Money Market Funds: Change is Coming

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INTRODUCTION

The money market fund industry is entering the final stages of a multi-year shift in regulatory requirements which will directly impact money market investors for years to come, including qualified plan fiduciaries. The purpose of this white paper is to provide a background of how we got to this point, a summary of the new regulations, an overview of the types of money market funds in the new regulatory environment, and a discussion of the key issues qualified plan fiduciaries should be evaluating with respect to the use of stable principal investment options within their plan's investment menu.

BACKGROUND

As of this writing, we are seven years from the date in 2008 when the US Treasury Department took unprecedented steps by establishing the Temporary Guarantee Program for Money Market Funds (TGPMM). This was a critical step in helping to stabilize US banking and credit markets, which could have been further tested had money market shareholders begun demanding cash on their current banking deposits.

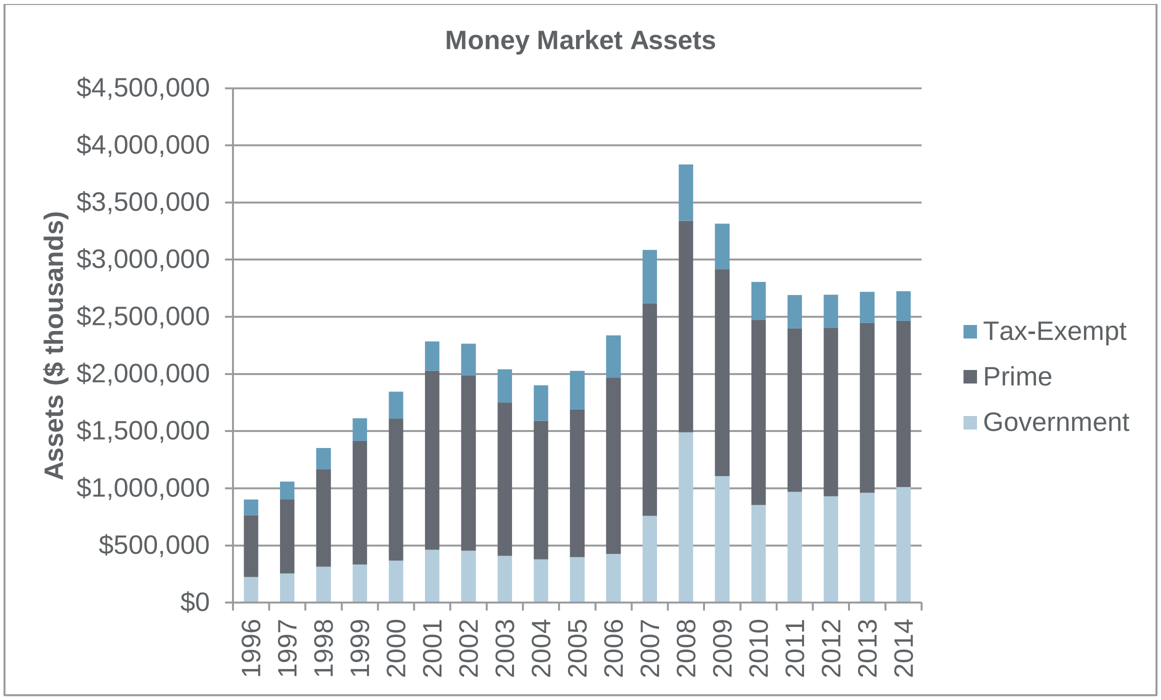
Most money market funds (although funds experiencing material distress at the time of the program's establishment were prohibited) signed-up for the program; those that did would have their proceeds guaranteed by temporary insurance. In exchange for the guarantee, participating funds paid 0.01% annually into the program. In practice, almost all eligible funds participated for fear of losing deposits to funds that opted into the guarantee program.

The program was initially scheduled to last for a period of 3 months, however it persisted for nearly a year. While many broad actions were taken in 2008 to maintain liquidity and security in open markets, the TGPMM was a particularly successful program. Over the 12 months of existence, the program had no claims and earned over $1 B in participation fees.

In the seven years since the 2008 financial crisis, numerous changes in laws and industry regulations have been passed with the goal of preventing future crises; new money market regulations among them. While the TGPMM was successful, the goal of new regulations was to avoid future emergencies from arising.

In an effort to reduce systemic risk in money market investments, and the externalities of those risks to the system as a whole, the Securities and Exchange Commission (SEC) proposed Rule 2a-7 in 2013. Rule 2a-7 is designed to limit money market investments in concentrated securities of single issuers. In 2014 the SEC adopted the final amended rule 2a-7 which created a gradual implementation of significant changes to money market mutual funds and how they are invested. The last of the phased implementation steps (to take place in the later half of 2016) will create new categories of money market mutual funds.

The stresses of 2008 do not seem to have materially impacted the size of the money market industry. While during the 2008 crisis money market issuers took huge deposits into Government Money Market Funds because they were perceived to have a lower rate of default risk, post-2008 asset levels across tax-exempt, prime, and Government Money Market Funds have remained steady[1].



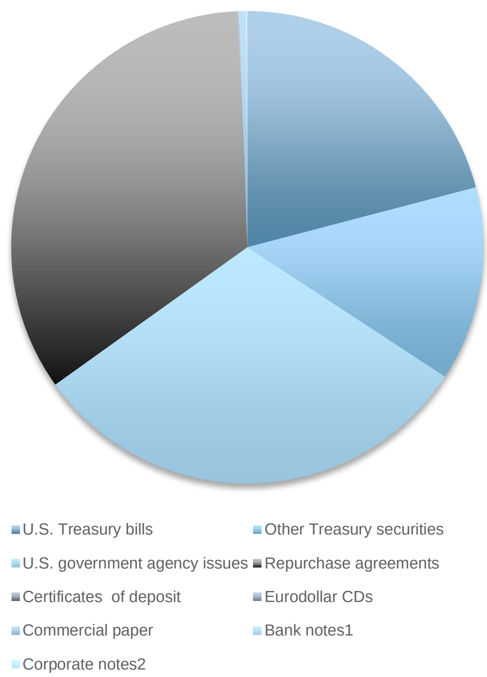
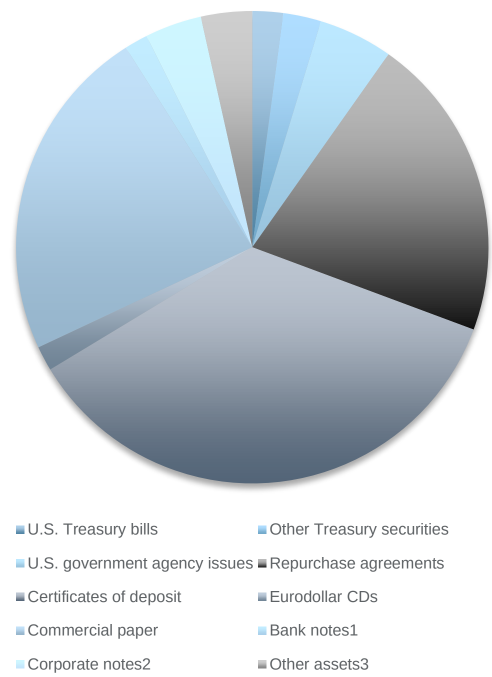
Money Market Fund Types

The new regulations create basically two types of money market funds: Government Money Market Funds and Prime Money Market Funds. [Please note for the purpose of this paper I will omit a discussion of tax-exempt money market funds, which typically are not used in qualified retirement plans.]

Government Money Market Funds typically invest in U.S. Treasury securities and securities issued by U.S. government agencies or “Government Sponsored Enterprises” such as Fannie Mae, Freddie Mac and the Federal Home Loan Banks. Government agency securities are not backed by the full faith and credit of the U.S. government, but are perceived by most to be more secure than non-government issuers. Government Money Market Funds may also invest in repurchase agreements collateralized by U.S. Treasury or other U.S. government securities.

[1] Data from Investment Company Institute

Prime Money Market Funds on the other hand, may invest in any eligible money market instruments as defined by the Securities and Exchange Commission under Rule 2a-7, including commercial paper, certificates of deposit, corporate notes, and other private investments.

Government Money Funds Investments[2]	Prime Money Funds Investments[3]
	

Rule 2a-7

The intent of the SEC in creating rule 2a-7 was to eliminate the threat that would be caused to the financial system if we experienced a systemic collapse of money market products. The initial phases of Rule 2a-7 focused on quality and diversification requirements that would reduce the risk in underlying holdings. The last phase of Rule 2a-7 is designed to ensure that money market investments that continue to take risks within the bounds of 2a-7 have features that would prevent a rush of distributions in times of stress.

To support this protection, Rule 2a-7 creates three potential asset preservation features that money market funds may choose to enlist.

Reform	Final Rule	Implementation Date
Floating NAV	• Applicable funds will price and transact at a net asset value per share that can change, or "float" based on pricing the underlying fund holdings out to four decimal places.	October 14, 2016
Liquidity Fee	• If a fund's weekly liquid assets were to fall below 30%, the fund's board may impose a 2% fee on redemptions • If a fund's weekly liquid assets were to fall below 10%, redemptions WILL BE subject to a 1% fee, unless the fund's board determines otherwise	October 14, 2016

[2] Data from Investment Company Institute
[3] Data from Investment Company Institute

Redemption Gate	• If a fund's weekly liquid assets were to fall below 30%, fund's board may suspend redemptions for up to 10 days	October 14, 2016

The history of money market funds, since their inception in the 1970's, was one of safety and liquidity. While Rule 2a-7 enhances the proposition for safety, the new liquidity restrictions will change how money market funds can and will be used by retirement plans. The table below shows at a more granular level the types of money market funds and the applicability of each of the new regulatory features. Generally, the new liquidity constraints will only apply to Prime Money Market Funds.

Fund Type	NAV	Liquidity Fee	Redemption Gate
US 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

Money market funds in defined contribution retirement plans are deemed as "retail" under the new rule. As a result, a Prime Money Market Fund would maintain the critical $1 share price, but potentially be subject to liquidity fees and redemption gates at the participant level. This may prove unreasonable to some plan sponsors in exchange for the very low rates of return.

Potential Impact of Rule 2a-7 on Defined Contribution Plans

The only money market investments not affected by the changes brought about by Rule 2a-7 are government money funds. We have already begun to see significant movement among mutual fund providers and plan sponsors away from Prime Money Market Instruments to avoid any potential redemption gates or liquidity fees. If this trend holds industry wide, the use of Government Money Market Funds will result in higher quality money market portfolios. However, in a world where risk and return are correlated, the use of higher quality government securities of ultra-short duration to comply with 2a-7 should reduce expected returns in an asset class where returns are already at or near zero.

Cash Equivalents Post 2a-7

Nearly all defined contribution plans offer one or more "cash equivalents" generally with the purpose of preserving value. While having a cash equivalent investment is not required in defined contribution plans, the language of ERISA section 404(c) (referring to different assets and participant choice) has cemented the use of cash equivalents in nearly every defined contribution plan. When selecting a cash equivalent for a defined contribution plan, there are three specific features (in addition to a number of qualitative factors) that plan sponsors ultimately need to prioritize in the evaluation: stability of value, liquidity, and yield.

Post 2a-7 and the new quality requirements for money market investments, plan sponsors can prioritize any two of these features albeit at the potential expense of the third.

Stability of Value

One of the primary attributes of cash equivalent investment options within the investment menu is to provide an option that has a stable principal value. For money market funds, this is the $1/share NAV that has always been a key feature of these types of products. In practice, most plan fiduciaries automatically assume stability of value is a requirement for cash equivalent investment options within the investment menu, as participants have a desire to have at least one choice where they “won’t lose money” from day to day.

Liquidity

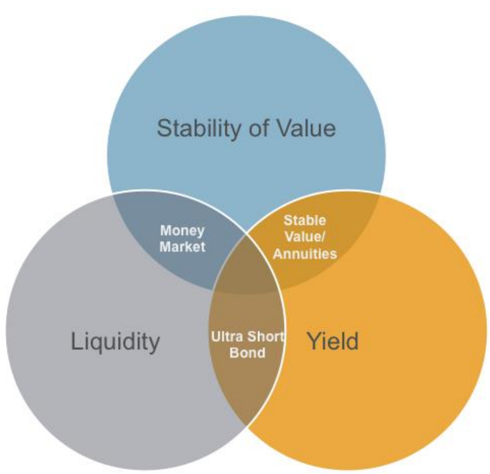
Within defined contributions plans liquidity is generally assumed to be ever-present. The new money market rules create constraints on the liquidity of some money market investments for the first time. For defined contribution plans, liquidity has two potential ramifications. At a participant level, consider whether restrictions in liquidity *might* inhibit participants from exercising the level of control necessary (under ERISA section 404(c)) to limit liability for fiduciaries. At the plan sponsor level, the potential of a money market fund to impose a redemption gate creates a challenge for plan operations that recordkeeping vendors may not be willing to support. Given the new regulations, liquidity is not a guarantee and plan sponsors need to determine how important daily liquidity is for both participants and at the plan level.

Yield

Cash equivalent investment options are not designed to provide capital appreciation, so their expected return is best approximated by their current yield. Within this space the two primary risk factors that affect yield are interest rate risk and credit risk. Rule 2a-7 shortened the permissible duration of money market securities and increased the requirements for investment in government debt which generally has a higher credit profile. As a result, money market funds will be constrained in generating yield relative to their historical performance even when interest rates rise.

Sophie’s Choice for Plan Sponsors

Before enactment of these final changes in 2016, plan fiduciaries should discuss the role of cash equivalents in their participant-directed defined contribution programs. Which of the three attributes you prioritize should drive you toward a preferred solution.



While there is no perfect answer to the question of how to use cash equivalents in your plan, committees and fiduciaries should acknowledge the tradeoffs and the intended use. Doing so will make the evaluation of products and returns more relevant. For the purpose of this paper we will touch only briefly on the alternative product constructs sponsors might consider as alternatives to a money market fund in their plan.

Stable Value Options

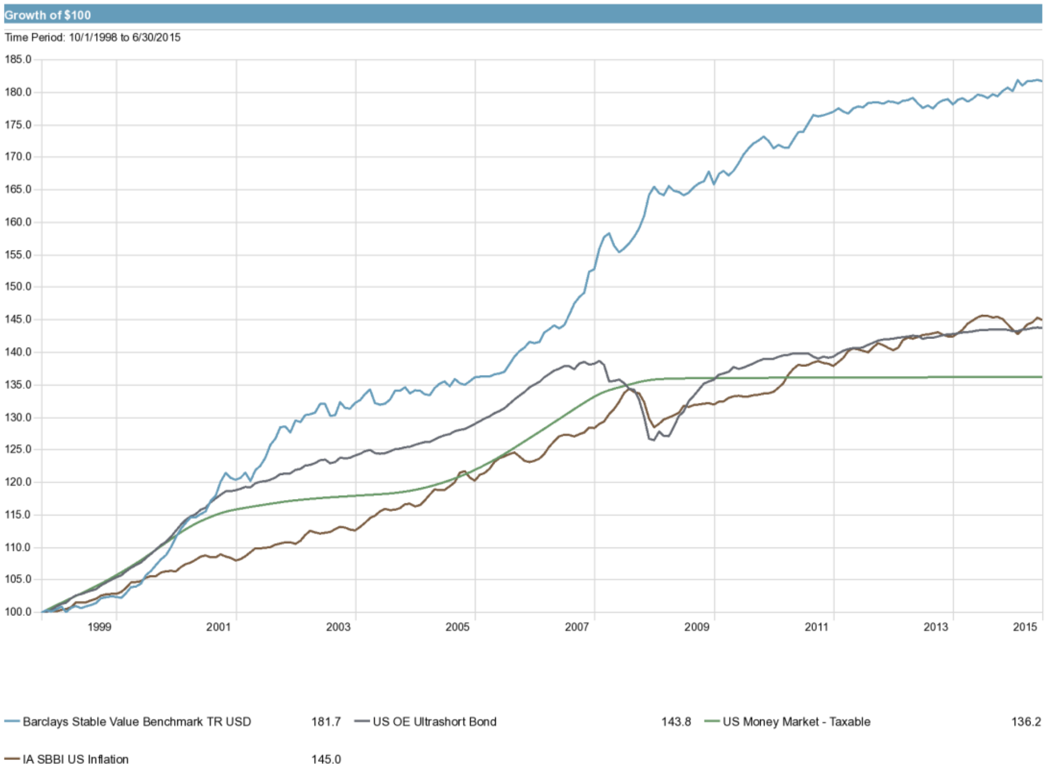
Stable value funds can include both wrapped bond portfolios as well as fixed annuity products from insurers. The objective of these products is to provide capital preservation coupled with steady, positive returns. For the wrapped bond portfolios, insurance contracts are wrapped around a short/intermediate duration bond portfolio to enable participants to transact in the fund at book value. Investment returns are smoothed using a formula to ensure that the book value of the portfolio generally tracks the market value of the bonds that make up the return stream. These products can either be purchased individually (for larger plans) or as part of a collective (shared by many smaller plans). While the longer duration and lower credit quality of most stable value bond structures provide higher returns, and the insurance provides stability of value to participants, material liquidity constraints exist at the sponsor level that limit the flexibility of plan sponsors.

Ultra Short Term bond

Ultrashort-bond portfolios invest primarily in investment-grade U.S. fixed-income issues and typically have an average duration of less than one year. This category can include corporate or government ultrashort bond portfolios, but excludes international, convertible, multisector, and high-yield bond portfolios. Because of the focus on bonds with very short durations, these portfolios offer minimum interest-rate sensitivity and therefore low volatility and total return potential. The benefit for plans is full liquidity and an expectation of higher returns attributable to the additional duration risk portfolio managers may take. The key drawback is that the daily value of the portfolio will fluctuate with changes in interest rate and as a result, the value of the portfolio may experience periods of declining principal value.

Returns Still Matter

The US has been in a low interest rate environment since the 2008 recession, and the prospect of a continued period of low rates seems plausible given the state of the economy. In this rate environment, accumulating fixed income returns is challenging and the three solutions for cash equivalents have very different histories of delivering returns.



Over the seventeen-year period we reviewed, money market returns trailed inflation while ultrashort bond returns generally were able to replicate inflation. Stable value type investments have generally been able to prosper, even when materially stressed such as in 2008 when defaults were higher. But like with all returns, these investments are accompanied by risk. Whether it is risk associated with the bonds in the stable value pool, or the health of the insurers guaranteeing stability in book value, the risks need to be understood.

	Portfolio	Advantages	Disadvantages
Money Market Funds	Ultra-short bonds, treasuries, and commercial paper. Money market holdings in mutual funds are subject to strict federal guidelines	• Generally considered the most secure and liquid place to store assets • Short-term portfolio responds rapidly to changes in the interest rate	• Participant misuse • Low returns, potentially less than inflation
US TREAS T-Bill Auction Ave 3 Mon 5-Year Return 0.06%[4]			
Stable Value Alternatives (GIGs and Fixed Annuities)	Bond portfolio or general account backed either by the issuing insurer or supported by a group of insurers guaranteeing stability of the book value	• Should provide a higher crediting rate than money markets over full market cycles • Position is backed by the full faith and credit of the issuer • Future returns are generally announced in advance	• Participant misuse • Liquidity constraints • Difficult to analyze • Cost structure is generally not determinable
Typical Fixed Annuity Return 1.5% – 3.5%			
Ultrashort Bond Funds	Short-term high-quality bonds, including asset-backed government, and investment-grade corporate securities. The majority of securities in the fund will have an expected maturity of 0-3 years, and will generally be held until maturity.	• Should provide a higher crediting rate than money markets over full market cycles • Short-term portfolio responds rapidly to changes in the interest rate	• Floating NAV makes the portfolio appear more “risky” than alternative asset structures
Barclays US Treas Bellwether 1 Year Index 5-Year Return 0.37%[5]			

CONCLUSION

When there is no clear answer, sponsors generally benefit from understanding the range of options.

1. Review your current portfolio and cash equivalent funding strategy
2. Adjust your investment policy statement to reflect the goals of the plan
3. Select the product(s) that meet your organizational objectives
4. Communicate the product benefits and limits to participants
5. Reassess

As with all issues of fiduciary prudence, continual evaluation is necessary as product options and enhancements may become available down the road.

[4] Returns as of June 30, 2015
[5] Returns as of June 30, 2015