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ViewPoint

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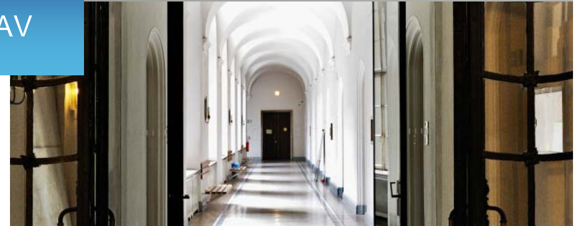
Money Market Funds: The Debate Continues

Exploring Redemption Restrictions, Revisiting the Floating NAV



Money market funds (MMFs) have been a topic of discussion — and often vehement disagreement — among regulators and market participants since the 2008 financial crisis and historic "breaking of the buck" by the Reserve Primary Fund. This single event cast scrutiny upon an industry that for the prior 40 years had successfully provided liquidity to the financial markets — and market yields to investors — without requiring government intervention. The result is the implementation of reforms that tightened standards and enhanced protections for MMF investors. (See summary of SEC Enhancements to Rule 2a-7 on page 2.)

> **While the proposed solutions are divisive, we believe the goal of the investment community and policymakers is one and the same: Reduce systemic risk without damaging money market funds' important role as a source of value to investors and funding to the short-term capital markets.**

Many in the industry believe that these reforms are sufficient. Regulators disagree and continue to explore ways to further strengthen the regulatory structure of MMFs. As an active participant in this dialogue, BlackRock has worked with others to formulate one or more capital solutions for MMFs. These are described in detail in a separate *ViewPoint* paper titled "Money Market Funds: Potential Capital Solutions," published in August 2011. To date, industry consensus on capital proposals has been elusive. This paper will focus on a model for MMF reform recently highlighted by the Securities and Exchange Commission (SEC) and currently under consideration. The SEC-proposed model would give money fund providers a choice of a stable-value MMF that incorporates capital buffers plus redemption restrictions or a MMF with a floating net asset value (NAV). Given that this plan is likely to be proposed by the SEC in the near future, it is important to fully evaluate its likely impact on MMFs and for market participants to identify features that may mitigate the potential negative impacts of these proposals.

Where Are We Now?

Fund sponsors, issuers and regulators agree on one key point: MMFs are essential as a source of short-term financing for businesses, institutions and governments and, as such, are critical to the financial system and the broader economy. Regulators' interest in fortifying the industry is derived from a constructive place and, indeed, the regulatory response in the wake of the 2008 financial crisis was both swift and effective.

That said, many fund sponsors argue that additional regulation would bring costs in excess of incremental benefits and believe that the 2010 reforms are sufficient. They contend that the measures imposed to date have met the goal

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The opinions expressed are as of March 2012 and may change as subsequent conditions vary.

Figure 1: SEC Enhancements to Rule 2a-7

The SEC published regulations for money market funds in 1983 to define and standardize the asset class. The regulations are known as Rule 2a-7 and were enhanced in May 2010. Those changes can be summarized as follows:

Credit Quality	► Reduced exposure limit for second-tier securities.[1] ► Funds not permitted to acquire second-tier securities with remaining maturities of > 45 days.
Diversification	► More restrictive single-issuer limits. ► More restrictive collateral requirements for repurchase agreements qualifying for "look-through" treatment.
Liquidity	► Reduced exposure limit for illiquid securities.[2] ► At least 10% of total assets in Daily Liquid Assets[3] (not applicable to tax-exempt funds). ► At least 30% of total assets in Weekly Liquid Assets.[4]
Maturity	► Reduced Weighted Average Maturity (WAM) limit. ► Weighted Average Life (WAL) calculated without reference to any provision that would permit a fund to shorten the maturity of an adjustable-rate security by reference to its interest rate reset dates.
Portfolio Stress Testing	► Performance of stress testing (simulated shocks such as interest rate changes, higher redemptions, changes in credit quality of fund) as required by new policies and procedures adopted by the fund Board.
Transparency	► Monthly disclosure of all portfolio holdings on the fund's website. ► Monthly filings of portfolio holdings and additional information ("shadow" NAV) with SEC.
Additional Board Powers	► Fund Board permitted to suspend redemptions and postpone payment of redemption proceeds if a fund will "break the buck" and if the fund will irrevocably liquidate.

[1] A second-tier security is defined as a security rated in the second-highest short-term rating category by rating agencies.
[2] An illiquid security is defined as one that cannot be sold or disposed of in the ordinary course of business within 7 calendar days at approximately the value ascribed to it by the fund.
[3] Daily liquid assets include cash, US Treasury securities, and securities readily convertible to cash within 1 business day.
[4] Weekly liquid assets include daily liquid assets (convertible to cash within 5 business days rather than 1) as well as US government agency discount notes with remaining maturities of 60 days or less.

of shielding MMFs and their investors from both idiosyncratic (fund-specific) and most systemic (industry-wide) shocks. They fear that further reform could do more harm than good. They point out that even in the case of the Reserve Primary Fund, institutional investors lost only 1%, and the government intervention that followed cost taxpayers nothing (in fact, taxpayers made a profit on the money market-related programs). Regulators, however, point out that the improvised steps taken to stem the run on the money markets in 2008[1] are no longer permitted under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). As a result, they believe further steps are needed to protect the industry and the broader economy from a potential run on money market funds.

SEC Chairman Mary Schapiro is prepared to move quickly on MMF reform and is seeking to issue a notice of proposed rulemaking (NPR) in the first quarter of 2012, with the goal of having a final rule in place this year. The final position of the SEC remains uncertain given mixed public comments from various commissioners. Opposition to the SEC's proposals from the industry and other market participants has also been strong and vocal. Some industry participants have indicated a willingness to pursue legal action if the Commission moves forward with plans that fundamentally alter the structure of MMFs.

[1] These include the Temporary Guarantee Program for Money Market Funds and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), both enacted in 2008.

What Next?

In seeking reform, the stated goals of regulators are: i) to reduce the risk of a run on MMFs and ii) to provide a cushion against losses, with a focus on the first issue. Over the past three years, many ideas have been proposed and discussed at great length; none has met with consensus. Various capital solutions have merit in their potential to meet regulators' stated objectives. However, different firms' legal structures make it impossible to find a single solution that works for everyone. At this juncture, given regulators' stated intention to move forward with structural reform, it is important to identify a proposal that preserves MMFs and is acceptable to as many industry participants as possible.

The model expected to be put forth by the SEC provides the option of either: i) a stable-NAV MMF with capital buffers plus redemption restrictions or ii) a floating-NAV MMF. The latter is not a new proposal, but one that continues to resurface as a potential option. In the following pages, we consider the merits and implications of these ideas. We also consider the case for whether regulators have already done enough.

Are Capital Buffers Plus Redemption Restrictions the Answer?

The most recent proposal under consideration by the SEC calls for capital requirements combined with restrictions on MMF redemptions. These liquidity restrictions come in a variety of forms; however, the one we believe to be under most serious

consideration takes the form of a "minimum account balance." Investors who wish to redeem their balance in full will be required to maintain a minimum account balance in the fund for a period of time before they can redeem the remaining amount. By holding back a portion of an investor's assets at the time of a full redemption and subjecting that investor to losses larger than if the investor had not redeemed, the theory is that investors will be discouraged from "running" in times of stress.

How could redemption restrictions work?

Under a likely model, redemption restrictions would be implemented as follows:

- Every shareholder in a MMF would have a "minimum account balance" requirement calculated daily.
- The amount of this balance would be some percentage multiplied by the shareholder's prior 30-day average or prior 30-day high-water mark.[2] For example, it might be 3% (or 5%) of the prior 30-day average. A shareholder that had $10,000 on average in a MMF over the last 30 days would have a $300 minimum account balance in this example.
- Minimum account balances are restricted from redemption. A shareholder wishing to redeem all or some of the minimum account balance would be required to wait a period of time before that is allowed. Current assumptions are for a 30-day waiting period.
- As long as a shareholder does not attempt to redeem below the minimum account balance, MMFs would continue to transact as they do today — at $1 per share. In this case, shareholders that never redeem more than 97% of their prior month average balance would not see any change in terms of their day-to-day interaction with the money funds.
- However, the anticipated proposal has an additional feature which is very significant. At any given time, the minimum account balance would not only be restricted from redemption for 30 days (as described above), but a portion could be subject to losses ahead of other shareholders ("subordinated") as well. In the event the fund breaks the buck, these subordinated interests would absorb losses after capital has been exhausted, but before other shareholders are impacted, thus providing an additional effective "contingent capital" cushion.
- The portion of the minimum account balance considered "subordinated" corresponds to how far below the prior 30-day average the shareholder's current balance is. (To be precise, the subordinated portion of the minimum account balance would be 1 minus the current balance, divided by the prior 30-day balance.) An example is provided in Figure 2 at right.

[2] For the remainder of this document, we assume the model is based on prior 30-day average balances. The model can also be driven off of prior 30-day high-water marks. That results in clients having, on average, approximately 30% more of their balances subject to the account minimum rules. This is because high-water marks produce larger numbers than averages.

How could redemption restrictions prevent runs?

To illustrate how this approach would, in theory, prevent runs, consider two identical shareholders in a MMF, each with a prior 30-day average balance of $10,000 and each currently with $10,000 in the fund. In addition, assume the fund has 50 basis points (bps) of capital buffer built up and that these are the only two shareholders in the fund.

In the event of a market scare, one of these shareholders (Shareholder A) decides to "run" by redeeming his entire balance, while the other (Shareholder B) redeems nothing. Finally, assume that the fund suffers a loss of $400 (2%).

- Shareholder A received a redemption of $9,700 — but the minimum account balance of $300 remained in the fund, and all of it is subordinated.
- Shareholder B also has a minimum account balance of $300, but none of it is subordinated.
- In this example, the $400 loss is apportioned as follows:
  - — Capital buffer of $100 (50 bps on $20,000) is wiped out.
  - — Shareholder A loses $300 (subordinated shares are wiped out).
  - — Shareholder B, the shareholder who did not redeem anything, suffers no losses.

As you can see, the structure imposes a greater burden of loss (i.e., "first loss" status for any subordinated component) on "runners" than it does on "non-runners." In the regulators' view, this structure will cause investors to thoroughly consider running, as a redemption could cause a portion of their balance to be subordinated to shareholders who do not run.

Figure 2: Calculating Amount of Minimum Account Balance "Subordinated"

The following example assumes a client begins with a prior 30-day average balance of $10,000. The client then either: (A) redeems nothing, (B) redeems half or (C) redeems the entire balance (subject to the account minimum rules). Below we show the outcomes of each scenario:

	Current Amount in the Fund	Required Minimum Account Balance	Amount "Subordinated"
A	$10,000	$300	$0
B	$5,000	$300	$150
C	$300 (for 30 days)	$300	$300

Can redemption restrictions work for MMFs?

BlackRock does not believe this structure will work for three critical reasons: i) Clients will not invest in MMFs with these redemption restrictions; ii) this approach may increase the likelihood of a run; and iii) there are enormous operational challenges in implementing this structure. Each of these three considerations is explained in more detail below.

In recent research, we tested a version of this idea in detailed conversations with our clients.[3] They were unequivocally negative on the idea, for a number of reasons. Importantly, many clients do not naturally remain above a minimum account balance. Analysis of our client base showed that 43% of institutional clients dropped below a 3% minimum account balance (based on prior 30-day average) at least once in 2011. 10% of clients did so regularly (i.e., more than five times in the year). Many of these clients go below the minimum account balance because of the nature of their business, which calls for a ramp-up of assets and then a redemption to zero. In addition, many clients operate under guidelines that prohibit them from using funds with redemption restrictions. For example, sweep accounts and collateral accounts must have access to 100% of their funds. Many clients also strongly dislike the fact that their balances could be subordinated to other shareholders and object to being “punished” for a redemption made in the regular course of business that happens to occur at a time of loss (the “innocent bystander” problem). Finally, clients find the structure difficult to understand and virtually without exception said that this model would cause them to abandon MMFs in favor of bank deposits or direct investments (in the case of larger clients). Liquidity is a key feature of MMFs, and an absolute necessity for many investors. Without full liquidity (at least in normal market environments), our view is that investors would not continue to invest in MMFs, resulting in substantial contraction of the industry.

However, the most telling input we received from clients was that they believed this approach would *increase* their likelihood of running in a financial crisis. Many of them told us that with a portion of their balance held back for 30 days *and* subordinated, they would choose to redeem much sooner — at the slightest sign of nervousness in the markets. The economists’ theory that clients would calmly weigh the costs and benefits of redeeming is contrary to what we heard in our discussions (and is contrary to the sometimes irrational behavior we observed in 2008). In this model, we believe clients would not take the time to navigate the complex structure and would be more likely to redeem earlier — and in this model, 97% of balances are open for redemption. Rather than preventing runs, we believe this approach would act to accelerate a run.

[3] During Q4 2011, BlackRock conducted in-depth interviews with over 40 institutional money market fund clients. In those discussions, we presented a variety of ideas for money market reform and asked for input on preferences, concerns and likely behavior. In particular, we focused on redemption restrictions, capital buffers and floating NAV.

Beyond client input, we believe this model will be difficult and costly to implement from an operational perspective. Transfer agent (TA) systems that process MMFs will need to be updated to do four new things:

- Calculate minimum account balances daily and restrict those shares from redemption (average or high-water mark over the last 30 days times a percent, such as 3%).
- Calculate the percent of the minimum account balance that is subordinated daily (1 minus the current account balance, divided by the prior 30-day average balance).
- For redemptions below the minimum account balance, age redemption requests for 30 days (in effect, process a T+30 day trade for any redemption request below the minimum account balance on that day).
- Address the omnibus problem. If omnibus relationships are treated as a single account, massive inequities could result. Consider an omnibus account with 100 clients each holding 1% of a fund. Clients would not be affected by the minimum account balance rule until after 97 of the 100 redeem in full. Then, if large redemptions were to ensue at any point, those clients who remain will find high percentages of their balances subordinated — potentially well above 3%. The alternative of resolving minimum account balances down to the sub-account level would require substantial new information sharing at the TA level, which presents its own complex and costly challenges.

While we believe each of these operational challenges can be overcome, the totality of these issues has the potential to make the operational re-engineering complex and expensive. In particular, the third and fourth of these challenges are the greatest. Given the client objections noted above, we believe fund sponsors and TAs will be reluctant to incur these costs given serious questions about the commercial viability of the product.

Are there alternative approaches to redemption restrictions?

A preferable alternative to this proposal is “stand-by redemption gates” that have an automatic trigger. Examples of an automatic trigger might include a fund’s liquidity dropping below a predetermined level or a fund’s marked-to-market NAV declining below a certain price. Liquidity restrictions would be enforced when a trigger is reached and lifted when a fund’s liquidity or marked-to-market NAV recovers to a specified level. The form of these restrictions needs to be defined and should include an option for sponsors to impose redemption fees.

The choice between stand-by redemption gates and the redemption restrictions described above depends on which is more likely to stop a run and which is less likely to accelerate a run. While some regulators contend that stand-by gates accelerate a run and that permanent redemption restrictions (with subordination) do not, our client research suggests just the opposite.

In essence, this is a difficult question of behavioral finance, and the answer is not entirely predictable. Given this uncertainty, we believe the stand-by redemption gates are preferable for three reasons:

- ► Based on our client discussions, stand-by redemption gates are less likely to cause clients to abandon the product in large numbers.
- ► The cost of implementing stand-by gates is much lower — avoiding many of the operational challenges described above.
- ► Only the stand-by redemption gates model can truly stop a run — by closing off all redemptions in a crisis situation.

What about the capital requirements?

The likely redemption restrictions proposal will also require capital. We understand regulators are likely to be flexible about the source and structure of that capital. We applaud this flexibility, given the challenge of a one-size-fits-all recommendation. However, we are concerned that a large variety of outcomes will be confusing to investors. Instead, we support specifying a few standardized options for fund sponsors, which provide flexibility at the same time as providing clarity.

The critical question remains: How much capital? From the outset, we have expressed concern that MMFs can only support a limited amount of capital. Regardless of the structure, the following are three important constraints that limit the amount of capital:

- ► First, sponsors are limited in terms of how much yield they can hold back to build a capital buffer or to pay for capital. Using historical yield data and assuming a 6-basis point charge to the fund, prime funds' yields would have been lower than government funds' more than 1/3 of the time. Looking forward, this relationship is sensitive and could result in substantial flows of capital among funds, thereby destabilizing the industry.
- ► Second, above approximately 70 basis points of capital, the money market industry will no longer return the industry cost of capital to fund sponsors. This suggests that any level of capital requirement greater than 70 basis points will cause the industry to contract (unless fees rise — creating a feedback loop with point #1 above).
- ► Finally, we believe capital requirements for stable-NAV funds would likely increase the relative attractiveness of a floating-NAV version to clients, further pushing them into those funds.

Is Floating the NAV the Answer?

A stable $1 NAV has been the hallmark, in fact, the very basis for the appeal of MMFs since their introduction in the 1970s. In the aftermath of the 2008 financial crisis, policymakers introduced the possibility of floating the NAV as an option for addressing systemic concerns with MMFs. We expect the SEC will include floating the NAV as an alternate choice for MMF sponsors in the new proposed rule.

Why float the NAV?

The idea of a floating NAV has met with strong, consistent industry opposition. The chief opposing argument is that modifying the very basis of MMF investing would result in MMFs losing an attribute (constant NAV) that is highly valued by investors. Regulators and other thought leaders, however, continue to return to a floating NAV as a viable and, for some, a favorable solution. Several have argued that a floating NAV reflects a fund's true market value, allowing investors to see regular fluctuations in their investment and provide a clearer, market-based assessment of the risks associated with a particular fund. Proponents believe that floating the NAV reduces the likelihood of a run on a fund because all investors receive the true value of their shares, regardless of when they redeem.

Can a floating NAV work for MMFs?

In July 2010, we published a *ViewPoint* titled "Money Market Mutual Funds: The Case Against Floating the Net Asset Value." We continue to believe that a floating NAV will not eliminate the risk of runs in money market funds and will substantially contract the industry. However, given the choice between a floating NAV and the redemption restrictions described above, we believe many of our clients will choose the floating NAV. As a result, more thought should be given to how a floating NAV might be structured to meet the needs of investors, regulators and fund sponsors. The discussion that follows is meant to start this dialogue. We recommend that the following be included in a floating-NAV proposal:

Prime and Municipal Funds

- ► Prime and municipal funds must use the 2a-7 portfolio rules to use the name "money market fund." This requirement would maintain a level playing field and would mandate conservative portfolios.
- ► Assets with less than 60 days to maturity should be allowed to use amortized cost accounting.
- ► A policy package should include an IRS de minimis rule for gains and losses given very small fluctuations in the NAV historically. This would be revenue neutral and would simplify administrative concerns of investors. The goal should be to eliminate the need for tax-lot accounting of money market shares.
- ► The transition strategy and timeframe are critical and must be carefully considered in terms of client education, mapping of assets and operational challenges.

Treasury and Government Funds

- ► Government funds should remain constant-NAV products. These funds do not present the same credit issues as prime funds. For investors who must have constant NAV, we believe this would be a reasonable (albeit lower-yielding) investment option.

Security Lending Pools and Common Trust Funds

- These vehicles also should retain a constant-NAV structure. Unlike publicly registered funds, these funds do not have the same liquidity needs and are not subject to the same type of run risk.

Capital Solutions Supplement

- A floating NAV should be supplemented with a plan that would allow sponsors to set aside capital on a voluntary basis. Note that it would require a change in current accounting rules to do this tax-efficiently. Many questions would need to be addressed here, including who would control the "rainy day fund" (e.g., fund sponsor, Board).

Clearly, a floating NAV remains controversial, and a great deal more needs to be done to evaluate its impact on the MMF industry and on investors. Many in the industry remain staunchly opposed to this idea, and there is good reason to be concerned. However, given regulators' strong inclination to pursue additional reforms, it is important for all interested parties to continue the dialogue to refine ideas and work toward the most beneficial solution.

Have We Done Enough Already?

No discussion of MMF reform would be complete without consideration of the question: Have we done enough already? Some in the industry have argued that sufficient action has been taken and that the $2.66 trillion[4] MMF industry is in a place of strength and stability today.

On February 7, 2012, Paul Schott Stevens, President and CEO of the ICI, wrote that the SEC proposals that remain on the table today, "are not necessary, particularly in light of the SEC's own success in reforming money market funds." Federated Investors has been outspoken in its view that enough has been done and recently published a paper titled "Leave Money Market Funds Alone!" in which it described the "bashing" to which MMFs have been subject since 2008 and the SEC's "conscientious and effective job" of overseeing the industry. The paper contrasts the SEC's ability to regulate MMFs with the Fed's oversight of banks. In the 40 years of their existence and regulation, MMFs have failed to meet the $1 redemption request only twice, and at no cost to the government. Over the same time period, more than 2,800 banks have failed at a cost of over $188 billion to the federal government. Specific to the floating NAV proposal, Federated cites the SEC's 2010 amendment to Rule 2a-7 that already gives a fund the flexibility to float its NAV if market prices do not support the continuation of redemptions at a stable $1 NAV. The paper cites capital buffers as similarly "off the mark" and notes that the SEC has already taken steps to increase fund liquidity considerably. Federated's bottom line: Replacing a successful regulatory program with an untested variation does nothing more than make MMFs and the economy "less efficient, riskier and more volatile."

> "The SEC has already made money market funds stronger. It should recognize its own success."
>
> *— Paul Schott Stevens, President and CEO, ICI, February 7, 2012*

In addition to the changes to MMF standards under Rule 2a-7 (outlined on page 2), numerous efforts have been undertaken worldwide to strengthen the broader financial system. In the US, these include the establishment of the Financial Stability Oversight Council (FSOC), which has the ability to provide proactive and more comprehensive monitoring of the financial markets, including money market instruments; and the implementation of the Dodd-Frank Act, which further bolsters the safety of MMFs by reducing risk in the instruments issued by financial institutions and held by MMFs.

A frequently overlooked point is that in addition to changes to MMFs themselves, regulators have substantially limited the ability of financial institutions to rely on short-term funding in their capital structures. This has perhaps been the most significant regulatory change of all. The result has been a reduction in supply of some of the short-term instruments most used by money market funds. Between December 31, 2007 and September 30, 2011, commercial paper outstanding fell 44% and large bank time deposits declined by 30%.[5] We believe the reduced reliance on short-term funding by financial institutions reduces the systemic importance of the money fund industry.

It appears that, in aggregate, these measures have been effective. MMFs have been functioning efficiently, with no systemic or idiosyncratic events recorded since the September 2008 breaking of the buck. In forming his argument, Mr. Stevens highlights the industry's ability, in the summer of 2011, to weather the ongoing European debt crisis, the downgrade of US debt from AAA to AA and a prolonged period of near-zero interest rates. While prime MMFs saw redemptions of about 10% in June-August, Mr. Stevens notes, the market was able to keep pace with redemptions and maintain liquidity with no change in marked-to-market portfolio values.

Despite the success of the 2010 reforms and the resilience of MMFs during periods of market stress over the past several months, Chairman Schapiro confirmed her intention to take action soon in remarks to the Practicing Law Institute on February 24, 2012. She stated that, "investors have been given a false sense of security by money fund sponsor support and a one-time Treasury guarantee" and "funds remain vulnerable to the reality that a single money market fund breaking the buck could trigger a broad and destabilizing run." Chairman Schapiro further noted that, "we need to move forward with some concrete ideas to address these structural risks."

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[4] Source: ICI; total retail and institutional MMF assets as of February 1, 2012.

[5] Source: Federal Reserve Statistical Release.

Conclusion

BlackRock, as one of the world's largest cash management providers, fully supports the goal of strengthening the MMF industry while reducing systemic risk. Throughout the 2008 financial crisis and its aftermath, the swift, decisive and concerted actions taken by regulators were essential in restoring confidence and order to the markets in a time of uncertainty. Many would contend that the new protections have met their goals. However, it appears that more change is imminent for the MMF industry. Faced with this very real possibility, it is important that all interested parties — policymakers, fund sponsors, industry organizations and corporate and municipal issuers of commercial paper — are part of the discussions to ensure the best outcome for investors, the MMF industry, the broader financial system and our economy. Ultimately, when contemplating additional change, it is critical to ensure that the reforms, both those implemented and those currently proposed, achieve the objective of protecting MMFs and the shareholders who invest in them without inadvertently destabilizing financial markets or increasing systemic risk.

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