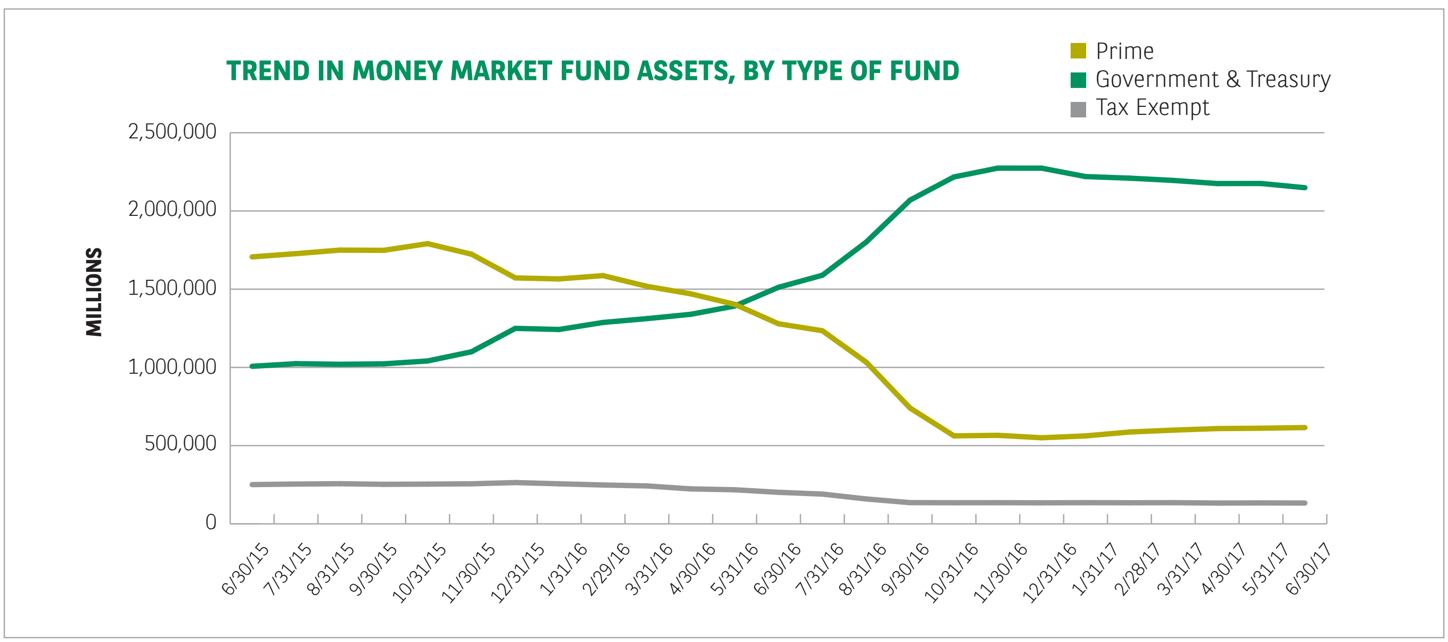
LIFE AFTER
MONEY MARKET MUTUAL FUND REFORM

If the financial crisis has taught us anything, it has shown that regulators have the ability to make structural changes to products that corporate treasurers frequently use to manage liquidity. From Dodd-Frank to Basel III, meaningful changes have been made to the financial sector in an effort to mitigate any perceived risk. Another significant regulatory change affecting how treasurers manage liquidity, Money Market Mutual Fund Reform, was officially enacted in October 2016. With meaningful changes to this traditional bulwark of short-term liquidity including a floating Net Asset Value (NAV) and redemption fees and gates, more than half a trillion dollars left Institutional Prime Money Market Mutual Funds (Prime Funds) just prior to the official date of the change.

The primary beneficiaries of the movement out of Prime Funds have been Government and Treasury Money Market Mutual Funds (Government Funds). In fact, since the beginning 2016, there has been nearly a $1 trillion shift of cash out of Prime funds and into Government and Treasury funds.[1]



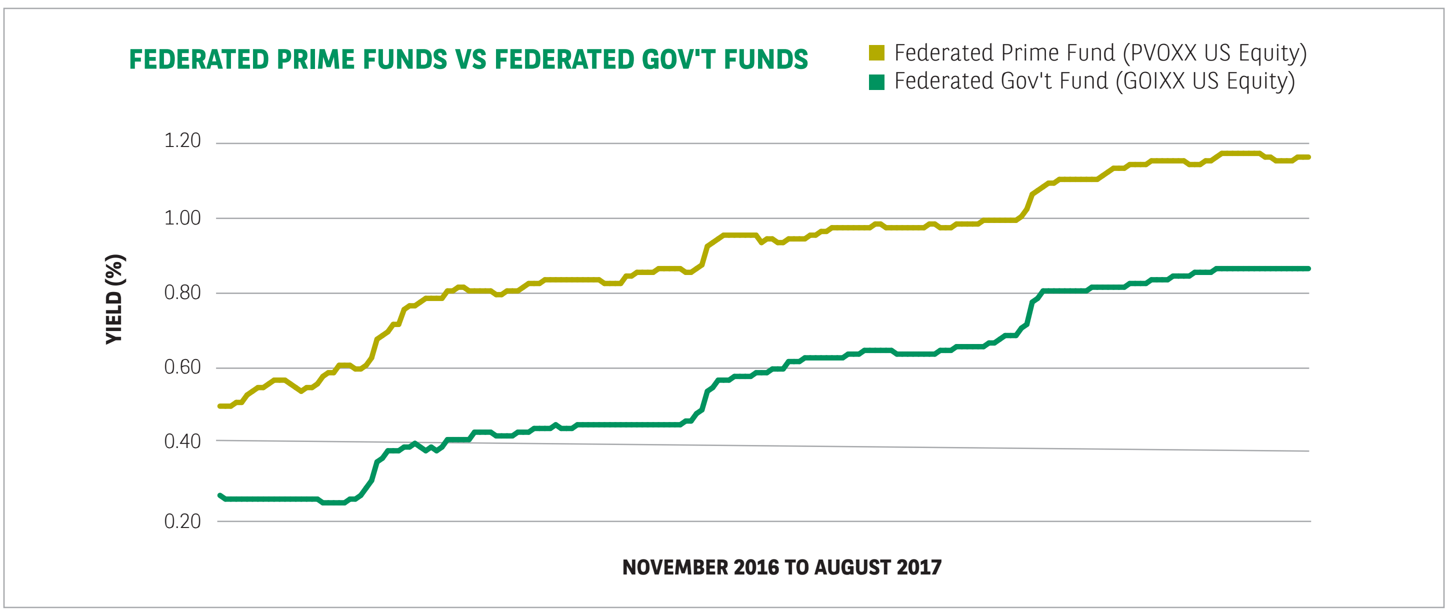
Source: SEC July 21, 2017

However, while Government Funds indeed maintain the same characteristics historically enjoyed by Prime Funds in terms of a stable NAV and no fees or gates, yields on these funds often trail other short-term liquidity options. With Government Funds continuing to trail Prime Funds by as much as 40 bps in some instances, and renewed attention to short-term investment instruments being generated by a rising interest rate environment in the U.S., corporate treasurers are invariably considering whether the move was to the proper investment vehicle. At the very least, corporate treasurers continue to explore what alternatives exist that can deliver similar operational benefits of Government Funds at returns that are more attractive than current yields. In short, they are seeking instruments that provide principal preservation with no fees or gates at an attractive return. This paper will explore what instruments might be the alternative of choice for corporate treasurers and what instruments could see an increase in volume in the coming months and years ahead.

TREASURY CASH: THE PIGGY BANK BEATS THE SLOT MACHINE

Most corporate treasurers strictly adhere to a company's investment policy guidelines; rules governing exactly where operating, reserve and strategic cash can be allocated and in what amounts. However, whether a corporate treasurer follows a well-defined written corporate plan or simply follows generally accepted Treasury principles, principal preservation is the overarching mandate in regards to how treasury cash is managed. It is this mandate to preserve principal that made a stable $1 NAV and no fees nor gates on redemptions of funds so attractive when utilizing Prime Funds as a liquidity option. Essentially, corporate treasurers need to know that when they put $1 into a liquidity or investment product, they can withdraw or have $1 returned.

The natural default product following the SEC changes to Prime Funds was Government Funds. Displaying similar characteristics of Prime Funds such as stable NAV, no fees and gates and flexibility to move to similar providers, made transferring to Government Funds a reasonable solution. In many cases, corporate treasurers had funds transferred to Government Funds from Prime Funds via a default option from their current providers or in the case of certain 'sweep' vehicles by choosing from a menu of options. While Government Funds are an excellent short-term liquidity product in terms of principal preservation and flexibility, they do have shortcomings. For instance, yields on Government Funds have lagged Prime Funds by as much as 40 bps following the change, including following an FOMC rate hike in March. Additionally, cut-off times for Government Funds are often earlier than Prime Funds, creating challenges for corporate treasurers to manage money until late in the day or near Federal Reserve close.



Source: Bloomberg September, 2017 Federated Prime Fund: PVOXX US Equity, Federated Gov't Fund: GOIXX US Equity

GOVERNMENT FUNDS AS AN ALTERNATIVE TO PRIME FUNDS

Advantages	***Shortcomings***
Stable NAV	Yield Lag (by as much as 40 bps)
Principal preservation	Cut off times

With several shortcomings in terms of yield and flexibility, treasurers should consider the following when moving from Prime Funds to Government Funds:

- Determine if the shift is a temporary phenomenon and what additional short-term liquidity products may be attractive alternatives. Time will tell whether there are enough compelling reasons to seek alternative solutions.
- For those who will be swayed by the need or desire to increase returns, or feel limited in their cash management flexibility due to early Government Funds cut-off times, some of their top choices will include bank deposits (demand deposit accounts or money market deposit accounts), repurchase agreements and time deposits.

KEY ALTERNATIVES TO MONEY MARKET MUTUAL FUNDS

Demand Deposit Accounts

Accounts allowing for unlimited deposits and withdrawals providing remuneration benefits either through earnings credit or hard dollar interest.

Money Market Deposit Accounts

'Savings' account allowing for up to 6 withdrawals in a reporting period unless made at a branch that pays hard dollar interest.

Repurchase Agreements

Collateralized short-term liquidity product that can be tailored for both maturity and type of collateral providing remuneration via a 'repo rate.'

Time Deposits

Fixed rate/fixed maturity liquidity product that generally offers higher yields with longer-dated maturities.

FOLLOW THE MONEY…POSSIBLY TO BANK DEPOSITS

BANK DEPOSITS

Most products including bank deposits, increase an investor's level of risk compared to Government Funds. However, bank deposits represent an attractive alternative because they offer daily liquidity, often until hours later in the day than Government Funds. In addition, depending on the operational nature of the funds in a bank deposit, this alternative may be attractive to many banks in helping improve key liquidity regulatory ratios. As a result of the funding benefit to banks and in certain circumstances regulatory benefits, bank deposits currently deliver competitive returns by as much as 50 bps or more vis-à-vis government funds depending on the depository bank.

Similar to Government Funds' current $1 NAV and dividends, an Interest-bearing Demand Deposit Account (IB DDA) or a Money Market Deposit Account (MMDA) will generally post interest on a monthly basis and the principal amount is the amount available for withdrawal on a daily basis[2]. Of all the product alternatives that exist for Government Money Funds, it is easy to argue that Demand Deposit Accounts offer the most comparable operational benefits as it is quite simple to move money to-and-from these accounts with remuneration and reporting also acting in a similar fashion.

Benefits

- Meaningful increase in return
- Daily access to funds
- Minimal risk (depending on the counterparty)
- Late access to funds

REPURCHASE AGREEMENTS

Repurchase Agreements (Repos) are a commonly used short-term liquidity vehicle that enables a treasurer to place funds at a bank or other financial institution for a defined period of time (maturity), receive collateral against the funds, and ultimately have the principal and interest on the funds returned at maturity. The rate used to calculate the interest paid at maturity is called the Repo Rate, which generally varies depending on both the maturity of the repo and the quality of the collateral that the treasurer requires to place funds.

Repos are another attractive short-term liquidity vehicle for treasurers because they can vary in maturity from overnight to up to several months or longer, and generally provide various types of collateral that dramatically reduces the risk associated with the product. In fact, in most instances, a treasurer can choose which type of collateral is required to enter into a transaction, collateral that can range from government treasuries to corporate bonds to equities. The arrangement between treasurer and a bank/ financial institution is often a "Tri-party arrangement," whereby a third party is made responsible for collecting and disbursing funds and ensuring the agreed upon collateral is indeed available.

Benefits

- Maintain high quality collateral
- Flexibility in maturity
- Competitive remuneration

TIME DEPOSITS

Daily liquidity is a key characteristic of all types of Money Funds which make them such an attractive investment. However, corporate treasurers routinely leave funds invested for extended periods of time, thereby treating Money Funds as a weekly or monthly investment. When used for daily liquidity, Time Deposits (TDs) can 'fit-the-bill' as an alternative given that TDs are fixed maturity (fixed or floating rate) deposit products that offer maturities from overnight to multiple years. While the yield/return pick-up on a TD may surpass that of a Government Fund, even on an overnight basis, corporate treasurers are likely to witness a more dramatic return enhancement vis-à-vis Government Funds with the ability to place funds out for a week, a month or more.

In addition to return enhancement, TDs represent an attractive alternative due to their ease of implementation. These instruments generally require limited documentation to establish and the investor can have funds wired directly into an operating account upon maturity. Certain types of TDs, like a Certificate of Deposit (CD), tend to offer other salient benefits, including an increased accessibility to cash given that CDs are negotiable in the secondary market.

Benefits

- Fixed maturity (fixed or floating rate)
- Operational ease (limited documentation)
- Increased accessibility to cash

MANY DECISIONS FOR LIQUIDITY MANAGEMENT... MANY PRODUCT ALTERNATIVES

Liquidity management is a multivariate equation requiring a myriad of considerations such as principal preservation, yield, risk mitigation, cash forecasting, human and capital resource management, etc. Any one of these variables can alter how cash is deployed to respective products and providers, with each having significant importance. Regulatory change in money funds, precipitating a significant movement of cash from Prime Funds to Government Funds, has many corporate treasurers seeking alternatives that produce increased yield with cash accessible until later in the day. From bank deposits, to repos, time deposits and more, product alternatives to Government Funds do exist and should be considered part of any corporate treasurer's approach to optimizing liquidity.

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1 Securities and Exchange Commission, Money Market Fund Statistics, 7/21/2016.

2 Money Market Deposit Accounts (MMDAs) are subject to Regulation D (12 C.F.R. 204), which is a Federal Reserve Board regulation that limits withdrawals on this type of account to up to 6 per month. Interest-bearing Demand Deposit Accounts (IB DDA) have no such withdrawal limitation.

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