ViewPoint: Money Market Mutual Funds

The Case Against Floating the Net Asset Value

13 July 2010

In the wake of the financial crisis, much has been said about money market funds. Did they contribute to the problem or were they victims of the credit crunch? How are they important to our financial system going forward? What changes, if any, should be made to reduce risk while maintaining the integrity of the product? The SEC Money Market Reform rules, effective in May 2010, together with the Dodd-Frank Wall Street Reform and Consumer Protection Act, have already gone a long way toward addressing some of the issues, but additional proposals remain on the table. Among them is a recommendation that money market funds — known and appreciated for their stable net asset value (NAV) — assume a floating NAV structure. In this paper, we make the case that such a change would not simply alter the nature of a single investment vehicle, but would have far-reaching implications and negative consequences for the entire financial system.

The Role of Money Market Funds

Money market funds are extremely important to our economy, acting as credit intermediaries matching nearly $3 trillion of issuers and investors. The issuers of short-term debt instruments include the US government and its agencies, corporations (including banks), and state and local municipalities. The investor side is equally diverse and includes corporations, municipalities, pension plans, trust funds, hospitals, universities and individuals; all use money funds for some portion of their operating funds or as a component of a broader portfolio. Money market funds are attractive to investors specifically because they provide a stable NAV and daily access to funds, while also offering a competitive yield versus bank deposits and direct investments. Prior to the unprecedented credit crisis of 2008, money market funds had successfully provided this service to the financial markets since the early 1970s without ever requiring government intervention.

The events of 2008, including the historic "breaking of the buck" by the Reserve Primary Fund, exposed both idiosyncratic (fund-specific) and systemic (industry-wide) risks associated with money market funds, and gave rise to several reform measures designed to mitigate such risks. The changes enacted to Rule 2a-7 — the rule governing money market funds — include more conservative investment parameters related to credit quality, maturity and liquidity, as well as enhanced guidelines around transparency to investors. The recent Dodd-Frank Wall Street Reform and Consumer Protection Act has imposed further safeguards that touch nearly every part of the financial industry.

As we move forward, the collective goal of the investment community and policymakers should be to manage risk while avoiding unintended negative consequences. The potential imposition of a floating NAV on money market funds is of particular concern. It is critical to preserve the stable value status of these investments, recognizing their importance to financing the needs and operations of companies, financial institutions and municipalities, and by extension, their contribution to the health of the broader financial system and the American economy.

Money Market Mutual Fund Facts

Money market funds have implications across the economy:

Jobs: Money market funds hold almost half of the commercial paper that businesses issue to finance payrolls and inventories. In addition, the contraction of the $2.8 trillion money market fund industry would result in the loss of thousands of jobs that support the functioning of that business, and would impact many more jobs that are indirectly tied to the industry through the funding it provides corporations and municipalities.

Communities: Money market funds hold nearly two-thirds of the short-term debt that finances state and local governments.

Retail Investors: Money market funds, because of their certainty of value, are used by individual investors as alternatives to traditional checking accounts and as a sweep vehicle to facilitate day-to-day transactions.

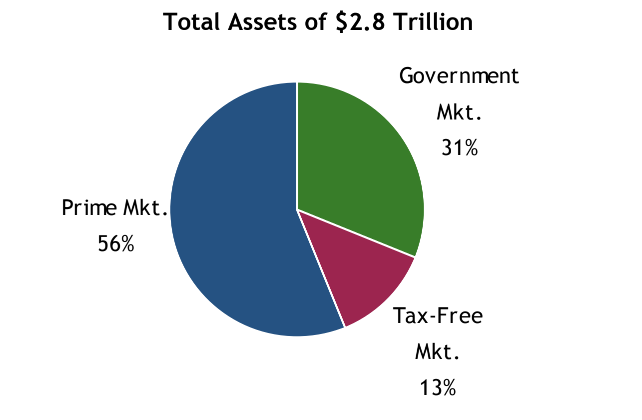
Corporations and Institutional Investors: Money market funds are used by commercial companies and institutional investors as an integral part of their working capital framework. They rely on a stable NAV to simplify tax reporting and recordkeeping and to ensure they meet certain "cash equivalent" requirements on their balance sheets.

Ordinary Americans: Money market funds hold significant amounts of the asset-backed commercial paper that finances credit card, home equity and auto loans.

US Government Financing: Money market funds hold one dollar out of every six in short-term paper issued by the Treasury.

Sources: BlackRock and the Investment Company Institute (ICI), 2010.

Figure 1: Total 2a-7 Market by Mandate



Data as of 30 June 2010
Source: iMoneyNet

The Issue: Floating the Net Asset Value

The SEC, in recognition of the events of the past two years, is exploring whether more fundamental changes to the regulatory structure may be warranted to improve money market funds' ability to weather liquidity crises and other shocks to the short-term financial markets.

While the SEC acknowledges that the stable NAV is a core feature of money market funds, some on the panel argue that a floating NAV would reflect a fund's true market value, allowing investors to see regular fluctuations in their investment and provide a clearer idea of the risks associated with a particular fund. Essentially, proponents argue that floating the NAV reduces the likelihood of a run on a fund because, in a crisis, the fund would redeem people at less than $1.00 per share, thereby reducing the incentive to leave and protecting the remaining shareholders. The idea of a floating NAV is among the most controversial of the recommendations related to money funds, and with good reason.

The Case Against Floating the NAV

BlackRock is among a diverse group of money market fund sponsors, industry organizations, individual and institutional investors and issuers that believe maintaining a stable NAV structure for money market funds is critical not only for liquidity markets, but for the broader financial and economic system.

The vast majority of investors use money market funds specifically because of their $1.00 NAV feature. For many investors, floating the NAV negates the value of the product. A floating NAV fund generates taxable gains and losses with each subscription and redemption, creating a tax and accounting burden for individual investors and for institutions that use these funds on a daily basis for their working capital.

Perhaps most notably, floating the NAV does not solve the underlying issue of investors fleeing the funds and disrupting the cash markets and the broader financial system. In the event of a significant decline in NAV, both retail and institutional investors are likely to leave floating NAV funds — and quickly. As evidenced by the experience of ultra-short floating NAV funds, which lost more than 60% of their assets from mid 2007 to year-end 2008, floating the NAV of a money market fund would not lessen the incentive for investors to redeem shares in periods of market turmoil, and may even increase systemic risk. Ultimately, shrinking money funds would result in a shortage of capital to buy commercial paper, impacting corporations' and municipalities' ability to fund their operations and also affecting the Fed Repurchase Program. The implications of floating the NAV are further detailed below:

Implications for Retail Investors

For many retail investors, money market funds are used as an alternative to a traditional checking account, or as a sweep vehicle within a larger account, to facilitate day-to-day transactions. Burdening investors with the complexity of taxable recognition of small gains and/or losses will undermine the convenience achieved by the money market fund structure. When asked, the vast majority of retail money market fund investors have indicated an unwillingness to invest in floating NAV funds, particularly after the implications are explained to them.

It is worth noting that over the past few years, several firms introduced "enhanced cash" and/or "low duration" funds as alternatives to money market funds. Collectively, these fluctuating NAV funds never achieved significant scale, performed poorly in the financial crisis, and were subject to redemption runs. Needless to say, investors do not consider these suitable alternatives to money market funds. According to ICI, at the end of 2009, investors held $2.9 trillion in taxable money market fund shares, compared to just $184 billion in floating-value short-term bond funds, despite their higher yields. ICI notes that this disparity "speaks volumes about the needs and preferences of investors."

Financial advisors also strongly favor the stable NAV for their clients and have indicated that they would be compelled to move clients out of money market funds into other stable value alternatives (such as bank deposits) if the NAV were to float. The advisors see this as part of their fiduciary responsibility, as money market funds are prized in client portfolios for providing certainty and accuracy of principal amount. Without this feature, advisors will look elsewhere for that characteristic.

Finally, sweep platforms, through which most retail investors invest in money market funds, are simply not equipped to handle a floating NAV. Rather than incur the costs for technology and operations to support a floating NAV money market fund, we would expect most sweep providers to simply replace money funds with another stable NAV product — the bank deposit. This would cut most retail investors off from the product.

In short: It is our opinion that retail clients strongly favor a stable NAV and will move a substantial percentage of assets out of money market funds if the NAV floats. Direct investors don't want tax consequences and seek the reliability of a stable NAV. Retail intermediaries feel a fiduciary duty to use stable NAV product for cash. In many cases, sweep systems cannot even handle fluctuating NAV.

Implications for Commercial Companies and Institutional Investors

Institutional investors have long relied on money market funds as part of their working capital framework. They value the certainty and accuracy of the principal amount in a money market fund, which provides a diversified, highly rated investment vehicle as well as a way to transact without triggering taxable events associated with gains and losses. When asked, institutional investors overwhelmingly favor a stable NAV.

Many institutional investors are bound by legal requirements or their own investment policies to invest in stable value products where the principal is protected. Still others are required by their internal guidelines to invest in stable value in order to receive "cash equivalent" treatment on their balance sheets. If money funds are required to float their NAV, many corporate treasurers, trusts and governments could no longer use them to manage their cash.

In short: Institutional clients, in our view, require a stable NAV and will move the majority of their assets to cash equivalents with a stable NAV if money market funds adopt a floating NAV. In many cases, investment guidelines require stable NAV, forcing the decision to move the assets.

Implications for the Broader Financial System

Money market funds are an essential part of the economic landscape, providing a substantial portion of the short-term funding to banks, corporations, government entities and municipalities. These funds for many years have served as a primary vehicle by which investors manage their cash balances, an amount equal to more than 36% of total US bank deposits.

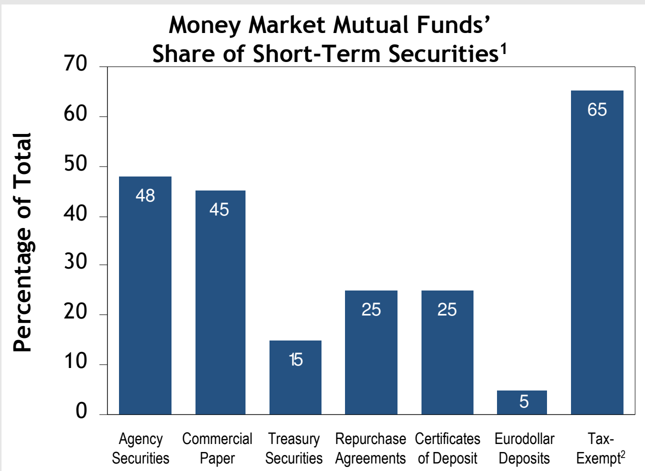
The clear risk in floating the NAV on money market funds is the substantial contraction of a product with $2.8 trillion of financial intermediary activity. As discussed, investors will be forced to look elsewhere for a stable cash alternative. Their choices will include bank deposits, direct purchases of Treasury bills and other commercial paper or cash equivalents. This will introduce concentration risk and will require credit research resources for prudent investment decisions. In this scenario, banks would receive significant deposits, but with no obligation to provide financing to the markets (i.e., commercial paper) previously serviced by the money market industry. Do we really think banks will do a better job if we give them all of this funding? Considering the current focus on "too big to fail," is now the time to increase deposits and reliance on banks as lenders?

A dramatic shrinkage in the money market fund industry and a commensurate shortage of capital to buy commercial paper will impact corporate issuers' ability to conduct business, municipal issuers' ability to budget and support their communities, and the Fed's ability to ease out of its stimulus program and ensure a self-sustaining economic recovery. Through its repurchase program, the Fed temporarily sells some of its securities to money market funds with an agreement to buy them back later. These reverse repurchase agreements essentially help the Fed to remove the unprecedented stimulus and associated liquidity injected into the system at the height of the credit crisis. A shrinking money market fund business could jeopardize the Fed's plan and the global economic recovery.

In addition, a contraction of the money market fund market will result in the loss of jobs directly and indirectly tied to the industry. Investment managers, custodians, mutual fund administrators and accountants have professionals dedicated to the special needs of money market funds. It is reasonable to assume that thousands of jobs are directly tied to the money market fund industry, with many more jobs indirectly linked to the industry through the cost-effective funding it provides corporations and municipalities.

In short: If money market funds move to a floating NAV, we believe investors will move the bulk of their assets to bank deposits, similar bank products, Treasury bills or direct purchases of commercial paper. It is our belief that banks are not equipped to provide short-term funding to the economy in the way that money market funds are through the purchase of commercial paper and other short-term debt instruments. This could result in a meaningful disruption to corporations, municipalities, our entire financial system and our economy.

Figure 2: Money Market Funds Are Significant Buyers of Short-Term Securities



[1] *Short-term securities include money market instruments as well as longer-term securities with a remaining maturity of 1 year or less.*

[2] *As of 12/08*

Sources: Investment Company Institute, Federal Reserve Board, US Treasury Department, Fannie Mae, Freddie Mac, Federal Housing Finance Agency and Federal Reserve Bank of New York.

Recommendations for Today: Less Disruptive Solutions

Clearly, the financial and economic environment has changed substantially since 2008. New SEC rules are designed to mitigate risk in investor portfolios, addressing credit quality, maturity structure and providing liquidity buffers. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act creates a Financial Stability Oversight Council and establishes a framework for identifying and tackling potential problems in the financial system. These measures go a long way in addressing the challenges that were faced, and posed, by money market funds in the Fall of 2008.

Given all of these changes, we believe policymakers should be careful to avoid unintended and potentially devastating consequences for the economy associated with sweeping changes. Instead, we recommend that emphasis be directed at incremental ideas, such as:

- **Allow for rainy day reserves.** Currently, the Financial Accounting Standards Board (FASB) does not allow money market funds or their sponsors to set aside reserves to protect against future losses. Without being able to point to losses, the FASB considers this practice "managing earnings" rather than prudent risk management. Changes that would legally allow sponsors to set aside reserves on a voluntary basis (i.e., create a "rainy day fund") could be meaningful in mitigating idiosyncratic risk.
- **Enhance disclosure.** Publishing a long-term, "rolling average" shadow NAV or including historical shadow NAV information in a fund's prospectus or SAI would give investors the ability to compare funds, while also discouraging short-term movements from fund to fund, which would increase the volatility of flows. However, we caution against going too far and providing the shadow NAV on a daily basis. This will not, we believe, improve shareholder decision-making because the shadow NAV of money market funds can be below $1.00 for extended periods of time (i.e., for years in a rising rate environment) for properly functioning funds that have no problems. In addition, the daily publication will not "desensitize" investors to NAV fluctuations, as these become much more pronounced in a time of crisis.
- **Anticipate and discuss red flags.** There is great opportunity to use the new oversight structure to flag potential problems before they become full-blown crises. The goal should be to establish a regular dialogue between money managers and the Financial Stability Oversight Council to broach issues and concerns in the short-term credit markets. This role would be comparable to the dialogue between the Treasury Department's Assistant Secretary for Financial Markets and various market makers and large bond investors.
- **Foster multi-agency dialogue.** Regular information sharing among the SEC, Treasury, Federal Reserve and Financial Stability Oversight Council, both formal and informal, will increase transparency and ensure that potential risks are understood by all parties and addressed promptly to avert a larger issue.
- **Convene a symposium.** A meeting of regulators, money market fund sponsors, issuers and investors to develop a constructive dialogue can help to ensure a model that works for the interests of all parties, the broader financial system and the economy.

Conclusion

Money market funds are critically important to the financial system, touching a wide array of issuers and diverse group of investors. They provide a source of funds for municipalities and private issuers of commercial paper and other short-term debt instruments, and afford a wide range of investors a competitive and convenient alternative for investing cash. Thousands of jobs are directly tied to the money fund industry, and many more are indirectly linked to the funding the industry provides to the economy.

Given money market funds' importance to so many parties, to the financial system and to the economy, it is clear that regulation and oversight is needed and required. In the past two years, much has been done to safeguard and enhance the functioning of the money fund industry, and more changes may be required at the margins. However, sweeping reform that would alter the very nature of this product would be counterproductive and result in unintended consequences. Modest changes and regular monitoring are less-disruptive solutions and seem the most prudent course at what is a pivotal juncture for the financial system and the economy.

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