WESTERN ASSET

Liquidity Management: A Changing Landscape

"All economic activity is by definition "high risk." And defending yesterday—that is, not innovating—is far more risky than making tomorrow."

–Peter Drucker

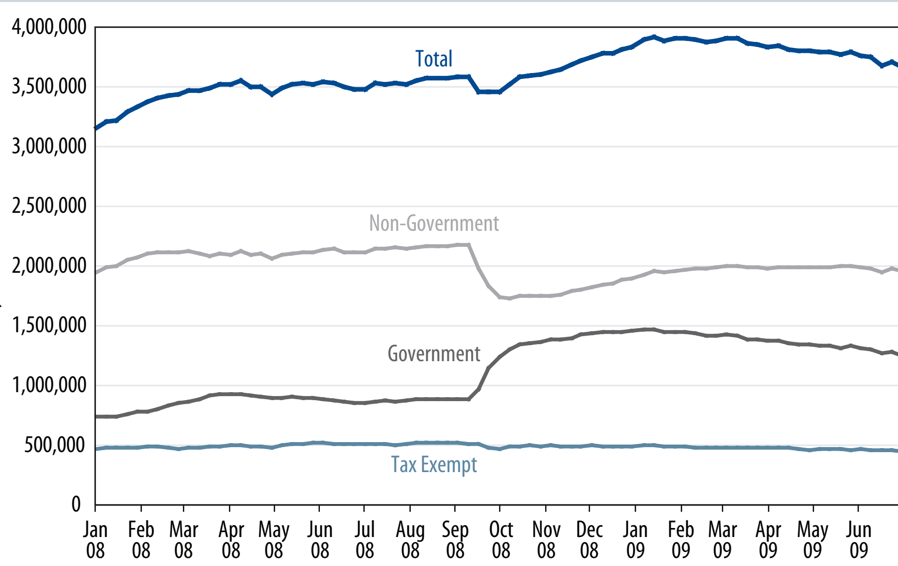
Recent market events have led the $3.7 trillion money market fund industry to reassess its operations. Proposed regulatory enhancements coupled with a Federal Reserve (Fed) near-zero interest rate policy could permanently alter the landscape of liquidity management. The current historically low yield environment has caused shareholders to shift from Treasury only money market funds to government and prime money market funds.

The first section of this paper summarizes the financial crisis from the money market fund perspective and outlines how the liquidity landscape changed in mid-September 2008 after the failure of Lehman Brothers. The second section discusses the role of money market funds and how the proposed regulatory changes to rule 2a-7 in response to the financial crisis may impact the industry. The last section concludes by discussing various liquidity management solutions that address the challenges described.

Money Markets and The Perfect Storm

By mid 2007 the difficulties in the subprime mortgage market had seeped into the credit and money markets. Despite these challenging conditions, money market funds performed well. During the period from July 2007 to August 2008, assets of money market funds increased by more than $800 billion to a total of $3.57 trillion. This significant increase can be attributed to the fact that money market funds were the primary recipient of the flight-to-quality as they offered principal stability, liquidity and a competitive rate of return.

Exhibit 1
Weekly Total Net Assets



Source: Investment Company Institute

As the financial markets seized in response to events such as the Lehman Brothers bankruptcy and the uncertain future of AIG, the need for liquidity and safety rose. Consequently, investors redeemed approximately $300 billion from prime money market funds, much of which flowed to Treasury-only money market funds (Exhibit 1). Fearing further redemptions, money market fund managers began to retain cash. Credit markets were virtually frozen as market participants refused to lend on more than an overnight basis. The TED spread, the difference between three-month LIBOR and three-month T-bill yields, is an indicator of credit risk. This spread, which historically ranged between 10 and 50 basis points (bps) until 2007, reached 463 bps in October 2008 (Exhibit 2). The federal government then began to intervene in unprecedented ways.

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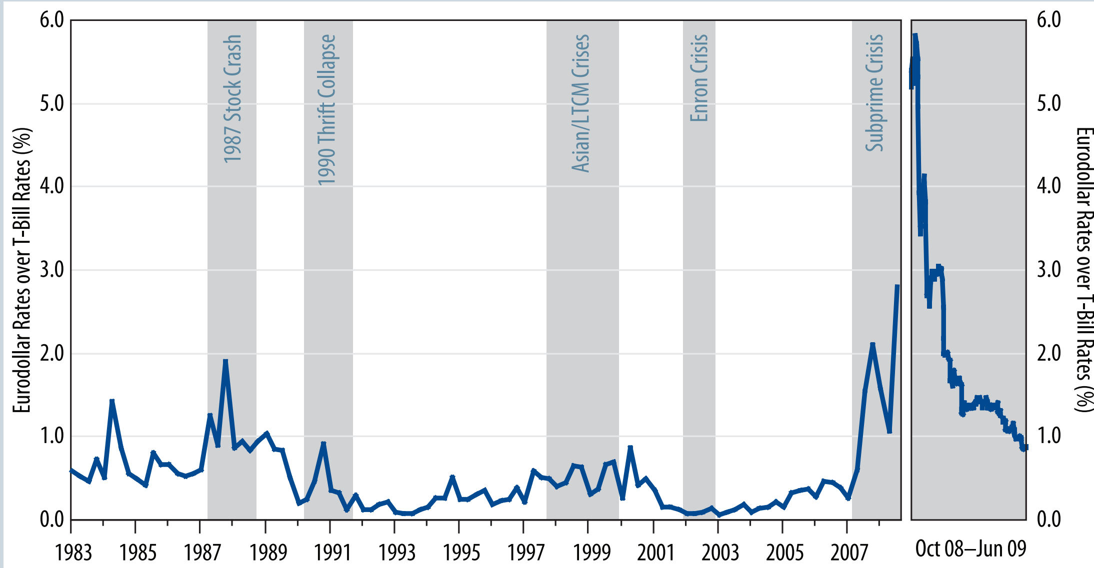
Exhibit 2
TED Spread



As of 30 Jun 09.
Source: Federal Reserve Board
Fed Spread: Spread of 3-Month Euro$ Yields over 3-Month T-Bill Yields, using last month of quarter data.

The Federal Reserve (Fed) and the Treasury Department announced a series of initiatives designed to provide stability and liquidity to the markets. Several of these programs were aimed at money market funds; namely the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF), the Commercial Paper Funding Facility (CPFF) and the Temporary Guarantee Program for Money Market Funds (Treasury Guarantee Program). These programs were successful in that they bolstered confidence in the short-term market. In fact, shortly following the announcements of these initiatives, outflows from prime money market funds subsided. By mid-October 2008 the assets of prime money market funds slowly began to grow and continued to do so into 2009. With this renewed confidence in money market funds among both retail and institutional investors, assets of money market funds reached $3.70 trillion by June 2009.

A Sea of Change: Increased Regulations for Money Funds

Although the crisis that faced money market funds has largely abated, recent market events have led the money market fund industry to assess the regulations that govern its operations. Over the past decade as money market funds have shown significant growth, their role as a financial intermediary has become increasingly important, and they have become a critical source of financing for businesses. Consequently, the regulation of money market funds is important to a wide variety of market participants.

In March of 2009 the Investment Company Institute (ICI), which had engaged in a wide-ranging study of money markets, submitted the Report of the Money Market Working Group for consideration. The group drew from recent experiences to develop a series of recommendations it believed would increase the resilience of money market funds during periods of market stress. The ICI was not alone in examining the regulation of money markets. The Securities and Exchange Commission (SEC) has been the regulator of money market funds under the Investment Company Act pursuant to rule 2a-7 under the Act for more than 25 years. Following the events discussed above, the SEC proposed a number of significant amendments to the rule after collaborating with various groups including the President's Working Group on Financial Markets and the ICI.

The amendments that the SEC has proposed are designed to strengthen the regulatory framework for money market funds, to increase their resilience to market disruptions and to reduce the risks of runs on the funds. The proposed amendments would, among other things, set explicit liquidity requirements for funds, limit their eligible investments to only the highest quality securities, shorten the weighted average maturity limits for funds, require monthly reporting of portfolio holdings

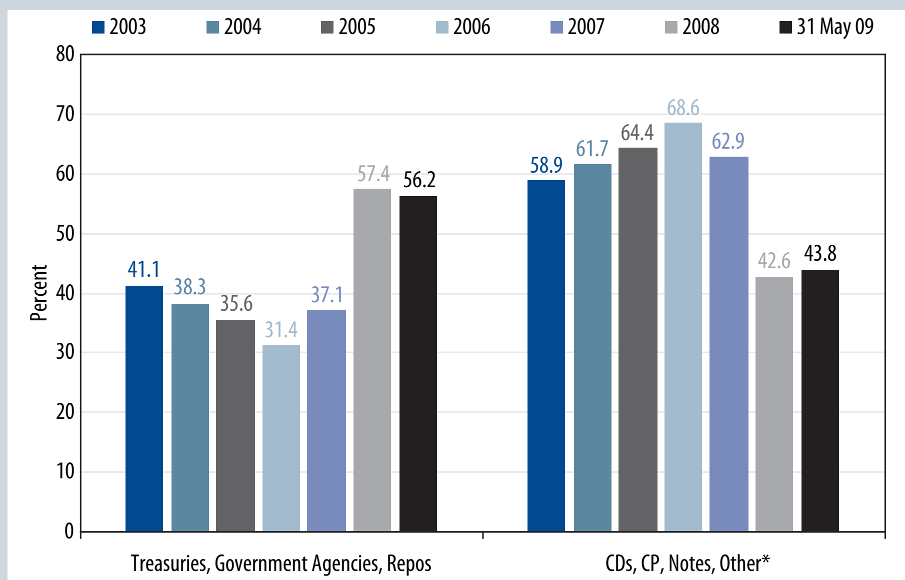
and permit a fund that has broken the buck to suspend redemptions while the fund undertakes an orderly liquidation. For a complete discussion of the SECs proposal and how they compare to the ICI's recommendations, please see Exhibit 4.

For nearly four decades, money market funds have offered principal safety, liquidity and a competitive rate of return. The $3.7 trillion money market fund industry will continue to offer an efficient, safe and liquid option for cash investors. Today, money market funds are safer and more liquid than they were just a few years ago. With further affirmation of the proposed SEC regulatory changes, prime money market fund managers have strategically altered their portfolio composition to seek more liquid securities and have shortened their weighted average maturities (Exhibit 3). Although other investment options may be considered in today's unique environment, we expect that money market funds will continue to be the primary investment vehicle for the lion's share of managed cash assets in the U.S., and will also remain a key intermediary in the U.S. financial markets.

The Changing Landscape of Liquidity Management: Challenges of a Near-Zero Interest Rate Policy

As the potential collapse of the global financial system moves further into the rear-view mirror and with the Fed on hold for an "extended period of time," the marketplace has witnessed a shift from Treasury only money market funds to government or prime money market funds and to customized separate accounts. Western Asset anticipates that this historically low yield environment will remain into 2010. Consequently, we expect the aforementioned trend to continue as money market fund shareholders who require daily liquidity and price stability shift to government or prime money market funds while those investors who do not have the need for stringent liquidity requirements or a stable net asset value shift to a conservatively managed customized separate account. In today's rate environment, such an option might be particularly attractive to institutional clients with limited near-term cash needs where the flexibility to invest outside of the realm of rule 2a-7 may provide the opportunity to enhance the return on the overall portfolio.

Exhibit 3
Asset Composition of Taxable Money Market Funds



**Other includes BAs and cash reserves. Notes are primarily corporate but includes some bank.*
Source: Investment Company Institute, Crane Data.

Exhibit 4

Money Market Fund Proposed Changes

	SEC Proposed Regulation	ICI Recommendation
Maturity Limits	▪ Shorten the weighted average maturity of a fund's portfolio to 60 days, instead of the current 90 day limit ▪ Restrict the maximum weighted average life maturity (spread WAM) to 120 days	▪ Shorten the WAM of a fund to 75 days, instead of the current 90 day limit ▪ Require funds to maintain a new spread WAM that does not exceed 120 days
Enhance Credit Quality	▪ Funds can only invest in the highest quality securities. No Second Tier securities	▪ Eliminate Second Tier securities from the definition of eligible security ▪ Require funds to establish a "new products" committee to review and approve new structures ▪ Funds should follow best practices in connection with minimal credit risk ▪ Retain references to NRSROs in Rule 2a-7 as an important floor on permissible investment ▪ Require funds to designate and disclose a minimum of 3 NRSROs that the fund advisor will monitor for purposes of determining eligibility of securities
Improve Liquidity	▪ Prohibit money market funds from buying illiquid securities ▪ Require funds to maintain a minimum daily and weekly percentage of assets in highly liquid securities ▪ Retail Funds: 5% in cash, US Treasuries or securities readily convertible into cash within 1 day and 15% liquid within 1 week ▪ Institutional Funds: 10% liquid within 1 day and 30% within 1 week ▪ Require funds to perform stress testing of portfolios to examine a fund's ability to maintain a stable NAV in the event of shocks, such as interest rate changes, higher redemptions and changes in credit quality	▪ Require funds to maintain minimum daily (5%) and weekly (20%) liquidity standards ▪ Mandate regular stress testing to assess a portfolio's ability to meet shocks, including credit risk, shareholder redemptions, and interest rate changes
Adopt "Know Your Client" Procedures	▪ Require funds to adopt procedures to identify investors whose redemption requests may pose risks for funds and remaining shareholders	▪ Require funds to develop procedures for admitting shareholders to their funds to ensure that funds either (1) understand the expected redemption practices and liquidity needs of investors or (2) when such information is not available, mitigate possible adverse effects that may result from such unpredictability ▪ Require funds to post monthly website disclosures of client concentration levels by type of client and the risks that such concentrations may pose the fund
Disclosure	▪ Require funds to post portfolio holdings on their websites within 2 business days after month end	▪ Require funds to provide monthly website disclosure of portfolio holdings ▪ SEC should adopt a rule applicable to advisers of unregistered funds, designed to reduce investor and market confusion about funds that appear to be similar to money market funds, but do not comply with Rule 2a-7
Processing	▪ Require all funds and their administrators to be able to process purchases and redemptions electronically at a price other that $1.00 per share	
Suspension of Redemptions	▪ Allow a fund's board of directors to suspend redemptions if the fund was about to break the buck and facilitate liquidation	▪ Allow a funds board of directors to suspend redemptions and purchases by the fund for a period of 5 business days in order to seek a "cure" for a fund that has either broken or reasonably believes it may be about the break a dollar ▪ Within 5 business days of announcing a suspension and liquidation, the fund's board must approve and the fund must announce to shareholders its plan of liquidation
Purchase by Affiliates	▪ Allow affiliates of funds to purchase securities from a fund in order to protect a fund from losses	▪ Amend Rule 17a-9 to allow a money market fund affiliate to purchase an eligible security from a fund ▪ Require nonpublic notice to the SEC of any affiliated purchase in reliance on Rule 17a-9

Source: ICI Report of The Money Market Working Group and the SEC Release No. IC-28807; File No. S7-11-09 Money Market Reform.
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