


YourTreasurer

CIPFA Scotland Treasury Management Forum AGM

Informative Presentation
Money Market Fund Regulation and Counterparty Issues

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Money Market Fund Regulation

2007	
June	USA Sub-prime mortgage crisis spreads to the off-balance sheet structured investment vehicles (SIVs) market which was funded by a combination of FRNs & ABCP bought by institutional investors/MMFs
July	2 Bear Stearns' hedge funds that invested in sub-prime assets (including FRNs and ABCP) filed for bankruptcy
August	BNP Paribas suspends withdrawals from its 3 investment funds that purchase FRNs - inability to access value of portfolio assets
September	Most MMFs suspend purchases of ABCP as fears grow about the quality of underlying collateral – also Northern Rock is nationalised by UK Government
October	Some MMF sponsors voluntarily 'lift out' any FRN holdings of mortgage-related SIVs at par value
November	Global banks begin to close their SIV operations and take the assets back on balance sheet while independents SIVs' are allowed to fail due to 'fire-sale' valuations
2008	
August	Reduction of $435 billion (37%) in ABCP holdings by investors (mainly MMFs) over last 12 months
September	Collapse of Lehman Brothers ; the U.S. Reserve Primary Fund 'breaks the buck'; major run on MMFs; Federal Reserve allows MMFs to access liquidity and provides insurance guarantee
October	HBOS rescued by Lloyds TSB takeover; Lloyds Banking Group (40%) and the Royal Bank of Scotland Group (80%) require UK government 'bail-outs'
2009	**The 'Shadow Banking System' debate starts in earnest with MMFs at the forefront..... .**

Money Market Fund Regulation

What is the Shadow Banking System?

A network of market-funded (rather than bank-deposit-funded) unregulated financial intermediary activities, undertaken by entities that do not accept bank deposits such as:

- Hedge funds
- Money Market Funds (MMFs)
- Non-depository banks (e.g. investment banks)
- Structured investment vehicles (SIVs) – also referred to as special purpose vehicles (SPVs)
- Non-bank financial institutions

but which also includes unregulated activities undertake by regulated entities (e.g. investment banks) such as:

- Credit default swaps (CDS)
- Securities lending

Estimated market size is $60 trillion!!

Money Market Fund Regulation

Why are MMFs considered part of the Shadow Banking System?

Regulators believe that MMFs may contribute to the amplification of global systemic risk for the following reasons:

1. The sheer size of the sector - estimated at over $4.2 trillion

2. They possess “money-like” attributes of bank deposits BUT they do not have “bank-like” insurance, nor can they access a central bank for liquidity support

3. Sponsor support may have material consequences for the balance sheets of bank sponsors

“Narrow banks in mutual fund clothing”

(Paul Tucker, Deputy Governor, Bank of England)

Money Market Fund Regulation

What is the current thinking on MMF regulation?

Securities and Exchange Commission (SEC)

1. Institutional MMFs should be required to move from stable to variable net-asset-values (NAVs) to reduce the risk of 'first-mover' advantage and a run on a fund

   and/or

2. MMFs to impose 'fees' and suspend redemptions (i.e. 'gate') to slowdown redemptions once a fund's liquidity assets falls below 15% of total assets

+ European Commission.......

3. MMFs to maintain a cash buffer of 3% of total assets value to help keep the financial system stable
4. Uniform rules to ensure minimum level of daily & weekly liquidity assets
5. Binding rules on types of investment assets, single counterparty exposure and restrictions on short-selling

Money Market Fund Regulation

What is the Industry Response?

In general, the industry welcomes any proposals to make MMFs even more resilient, provided that:

1. Any changes preserve the key features that have made them so valuable to both investors and businesses that rely on them for funding
2. Any changes preserve choice for investors by ensuring a continued robust global industry

The Institutional Money Market Funds Association (**IMMFA**) continues to have constructive dialogue with the European Securities and Markets Authority (**ESMA**) and has put forward the following counter proposals:

1. Implement further transparency, liquidity buffers and "know your client" requirements
2. Impose liquidity fees and redemption gates in stressed market conditions
3. Any transactions between a MMF and its sponsor should be clearly defined in regulation and either prohibited or require explicit prior approval

However IMMFA opposes the cash buffer proposal on economic grounds as well as the proposed change from a constant to a variable NAV as unlikely to prevent a run in stressed market conditions

Money Market Fund Regulation

So what is my personal view on the regulation debate?

1. The Regulators response is understandably skewed towards minimising systemic risk **BUT** they have lost sight of treating customers fairly and the fact that it is an investment product
2. The 'constant' versus 'variable' net-asset-debate is a red-herring that can easily be covered by enhanced sales practices and prominent investment risk warnings
3. The alleged advantages of VNAV for investors is a flawed argument since:
   - It is conveniently forgotten that MMFs are "hold to maturity" funds, so why apply a sales spread to Money Market Instruments that are unlikely to be sold?
   - In severe stressed market conditions, there is no such thing as a real market price as either 'Fire-sale' or 'fiction' becomes the mark-to-market price....
4. The real 'elephant in the room' remains as to how the shadow banking sector will be able to access liquidity in severe stressed market conditions !!
5. However, the increased transparency and the recent proposed enhancements by the industry are positive moves which for too long were vetoed by compliance departments

My prediction is that constant NAV funds will continue to be permitted here in Europe subject to liquidity fees and redemption gate safeguards.

Money Market Fund Regulation

So what does this mean for CIPFA Scotland members?

On the whole, positive implications for Scottish Local Authorities.......

1. Enhanced information and transparency from MMF providers

2. Product and structure recognised by the Prudential Regulation Authority (PRA)

3. Potential for CIPFA members to launch their own MMF product range perhaps??

Counterparty Issues
Challenges facing Local Authorities

1. Official investigations into the causes of the global financial crisis highlighted some serious shortcomings in the due-diligence process for selecting & monitoring counterparty banks

2. Among other things, these investigations identified a number of shortcomings of relying solely on published credit rating information

3. Most Treasury Strategy Statements ('TSS') only set minimum credit rating requirements but do not set minimum requirements for other assessment criteria (e.g. CDS prices)

4. The TSS may contain a requirement to suspend credit lines if a 'negative outlook' has been applied by a credit rating agency which also results in higher concentration risk

5. In light of these factors, local authorities are overly-reliant on their external treasury consultants for guidance - who in turn are restricted in what they can suggest owing to the lack of measures

The maxim *"Don't make what you can't measure"* comes to mind !!

Counterparty Issues

Shortcomings of Relying solely on Credit Ratings

1. Tick box methodology cannot cope with fluid market conditions and largely ignores commercial considerations
2. Rating changes advised by general press releases giving insufficient time for depositors to take mitigation action
3. Timing of actions by CRAs tend to lag behind market opinion - typically by 6 months
4. Credit ratings over-reliant on perceived support implications rather than on detailed due-diligence assessments
5. Studies show that the CRAs are biased towards the larger complex groups at the expense of smaller banks
6. Potential conflict of interest inherent in "issuer pays" model
7. Open to credit rating arbitrage by banks as no obligation to disclose preliminary ratings given to banks

Moody's Investors Service

STANDARD &POOR'S

FitchRatings KNOW YOUR RISK

Counterparty Issues

Some specific comments.....

"Credit ratings should not be used in isolation as a justification for the soundness of an investment and local authorities should be made aware of the fact that credit ratings should be viewed within the context of wider financial and economic information and advice."

Communities and Local Government Committee Local Government Investments Special Report ; Oct 09

"In light of the shortcomings in the current rating process, public policy should encourage alternative sources of credit rating information. Recent work by Bloechlinger, Leippold and Maire (2012) shows that one can produce corporate credit rating measures at par or superior to that of the credit ratings agencies at almost no cost using public information only. The latter suggests that the three largest rating agencies owe their predominance in the market for corporate ratings more to regulatory privilege than information advantage."

"In most countries, bank regulators protect their privileged data access, and do not share crucial bank data publically (or even with other bank regulators) in a narrow pursuit of their own agency power and to shield themselves from accountability. Future bank regulation therefore needs to create an entirely new information environment for external credit analysis. Better public information and more bank reporting is the best strategy to reduce the power and exorbitant influence of rating agencies in the current system."

Bank credit ratings: What determines their quality? April 2013. Harald Hau, Sam Langfield and David Marques-Ibanez Université de Genève, **Swiss Finance Institute and CEPR**; European Systemic Risk Board Secretariat and UK Financial Conduct Authority; European Central Bank, Financial Research Division.

Counterparty Issues

Example of an Alternative Due-Diligence Service Approach

1. Developed a wider due-diligence process to complement the role of the credit rating agencies and not to compete with them

2. The methodology applies a wider information-based due-diligence approach via a credit score model that:

   - Captures a broad range of diverse credit information data points from a variety of sources.
   - Applies individual quantitative or qualitative risk scores along with individual risk weightings
   - Provides a comparison of the outputs against a 'model bank' and against a peer group of banks

3. This type of service is intended to support the wider corporate governance scrutiny responsibilities of directors and risk managers – including local authority requirements

Here are some sample reports to assist understanding.......

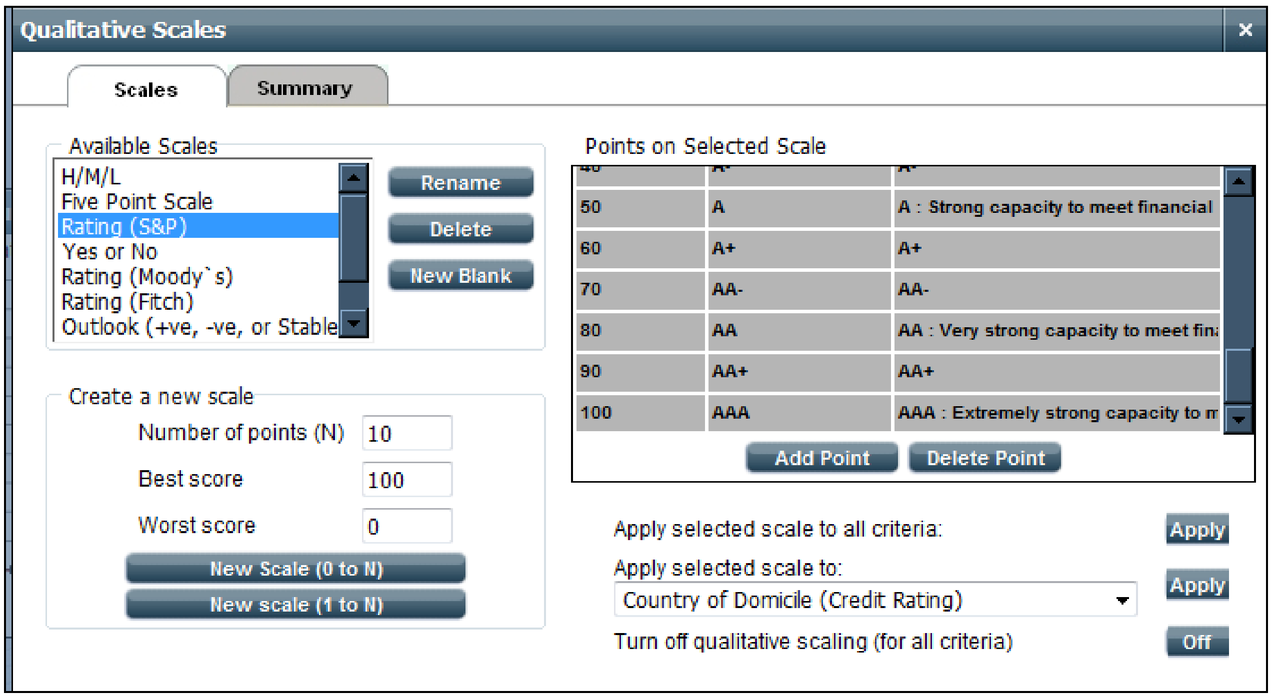
Counterparty Issues

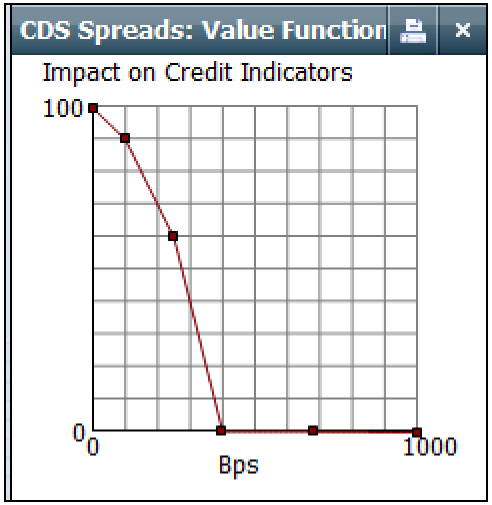
Example of a Due Diligence Assessment

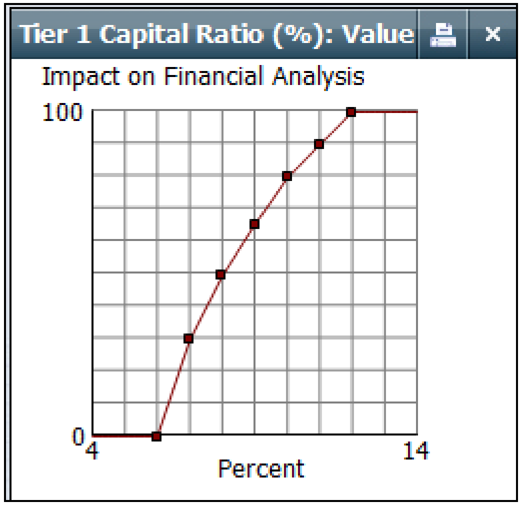
	Counterparty Bank Name : Santander UK plc (Parent - Banco Santander Group)			**Review Date: 31 August 2012**	
No	**Requirement Description**	**Criteria**	**Actual**	**Comments**	**RAG Status**
	General:				
1	Country of Domicile - Credit Rating **(S&P)**	AAA	UK - AAA	UK economy recovering – budget deficit tackled	Green
2	Access to Central Bank liquidity	Yes	Yes	Clearing bank status – direct access to BoE liquidity	Green
3	Eligible for future Credit Guarantee Schemes	Yes	Yes	Although Scheme closed has used it in the past	Green
4	Tangible Parental Support (subsidiaries)	Yes	Yes	Ultimate parent provides equity shareholding	Green
5	Authorised Institution for FSCS purposes	Yes	Yes	100% protection of up to £85k for eligible claimants	Green
	Credit Indicators: **as at 31 August 2012**	**LT Rating Outlook**	**LT Rating Outlook**		-
6	Standard & Poor's	A Stable	A Stable	Stable outlook on strong operating performance	Green
7	Moody's	A2 Stable	A2 Negative	Negative outlook on Parent reputational risk concerns	Amber
8	Fitch	A Stable	A Stable	Stable outlook on strong operating performance	Green
9	Latest CDS Spread	<250bps	274bps	But stronger credit than Spanish Parent (384bps)	Amber
10	Annual Share Price Movement	Max 15% fall	0%	Moderate fall reflecting its UK-centric risk exposure	Green
	Financial Analysis: **as at 30 June 2012**	**Criteria**	**Actual**	Currency Foreign Exchange Rate =	**1.00**
11	Total Shareholder Funds (including Reserves)	Min £500 (m)	£13,361	Equates to 0.08% of TSF per £10m of credit exposure	Green
12	Tier 1 Capital Ratio (%)	>10.0%	15.5%	Up from 14.8% - will decline on purchase RBS branches	Green
13	Regulatory Total Capital Ratio (%)	>12.0%	21.7%	Exceptionally strong ratio through debt issuance	Green
14	Leverage: Shareholder Funds/Total Assets (%)	>5.0%	4.8%	Improving trend – up from 4.7% for at 2011 Y/E	Amber
15	High Quality Liquid Assets/Total Assets (%)	>10%	22%	Well above minimum liquidity of 10% for ILAS purposes	Green
16	Customer Deposits/Funding Base (%)	>50%	56%	Conservative funding approach	Green
17	Total Loans/Customer Deposits (%)	<100%	133%	High but improving trend from 136% as at 2011 Y/E	Red
18	Impairment Charge/Customer Loans (%)	<-0.5%	-0.4%	Quality loans-one of the lowest ratios of their peer group	Green
19	Pre-Tax Profit/Revenues (%)	>20%	33%	Stong performance-trending lower on higher Interest costs	Green
20	Cost-to-Income Ratio (%)	<-50%	-51%	Significantly better than most of their peer group	Amber

Counterparty Issues

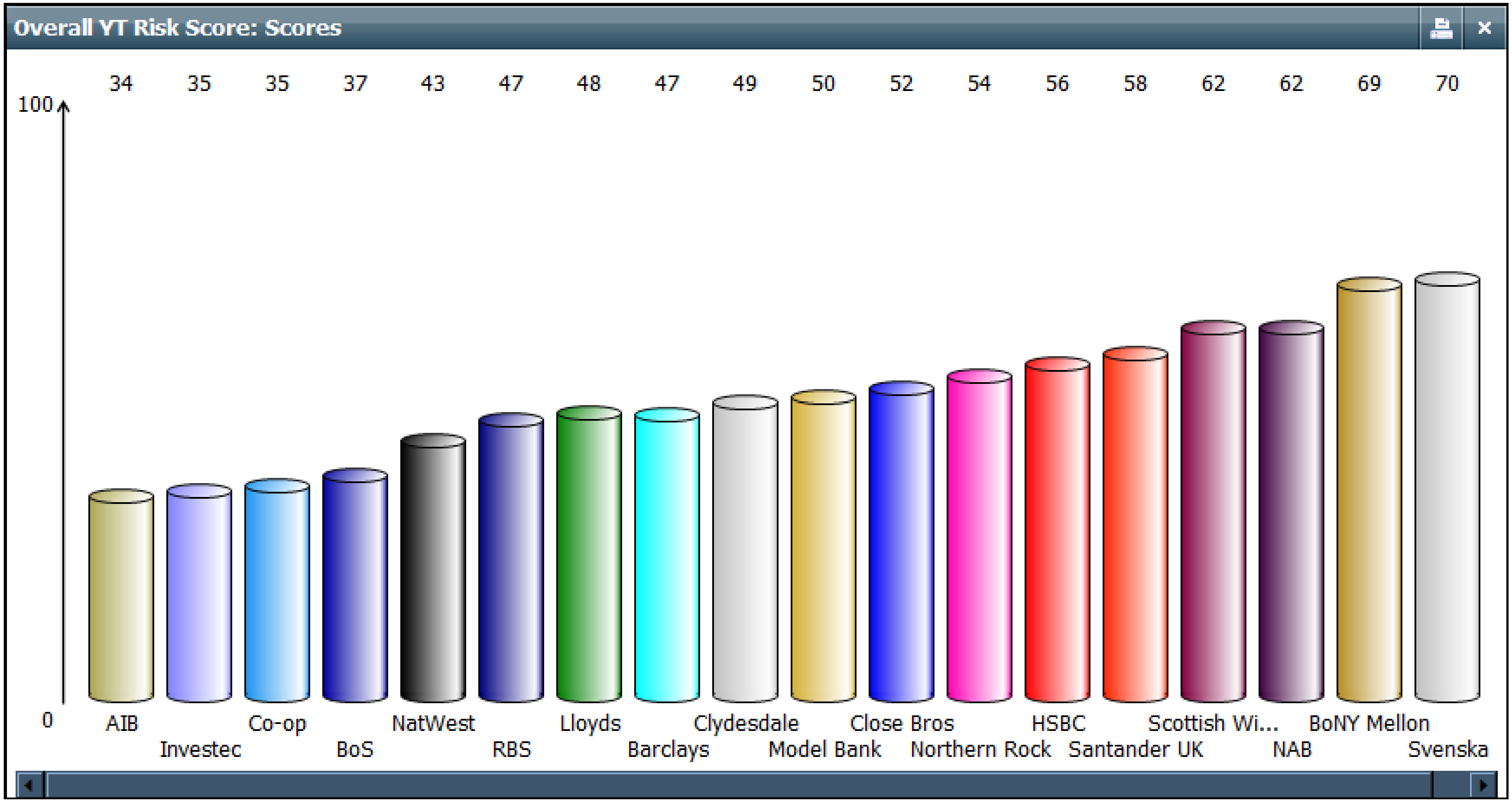
Defining the Model Scaling (Examples)



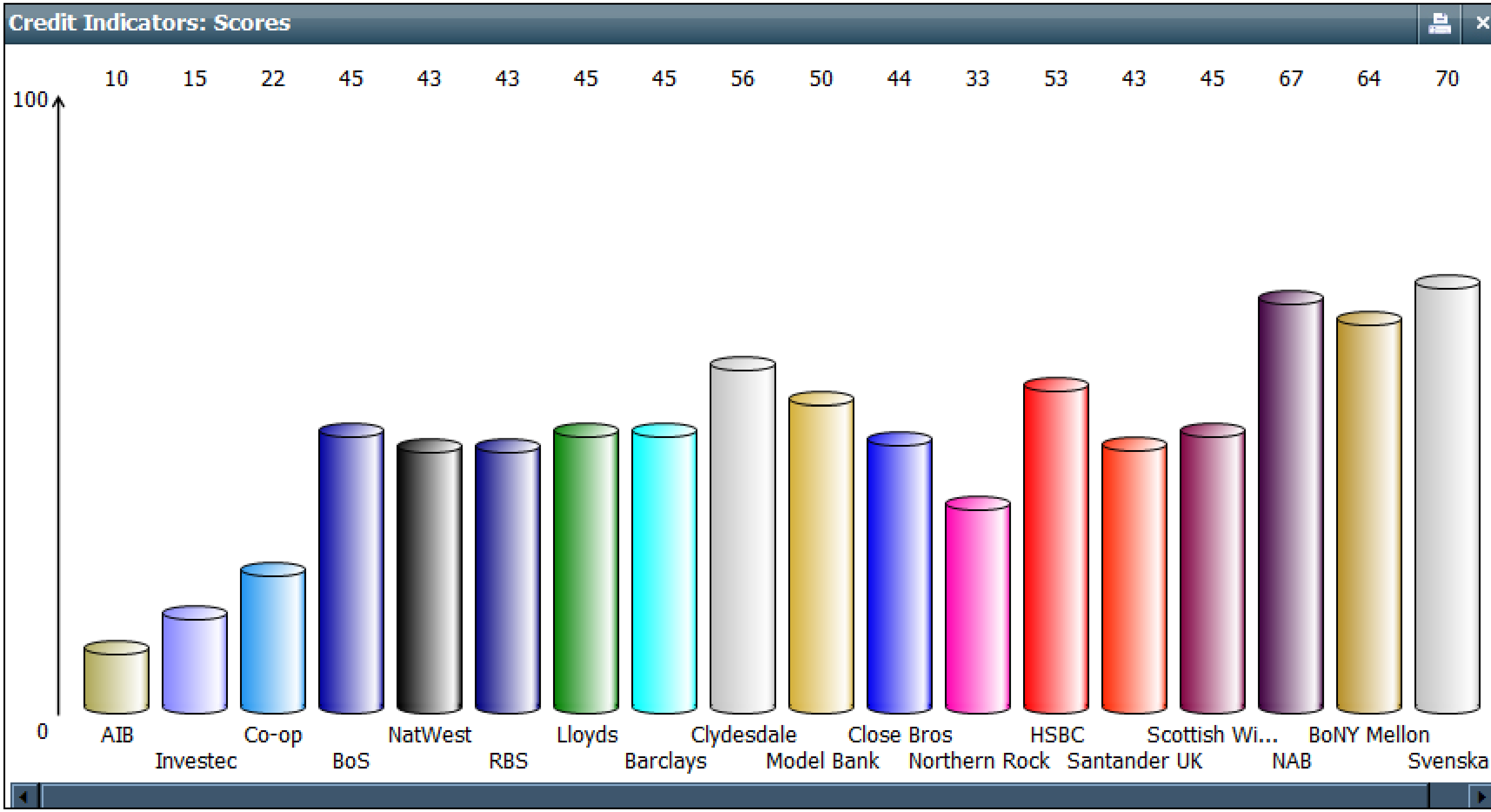




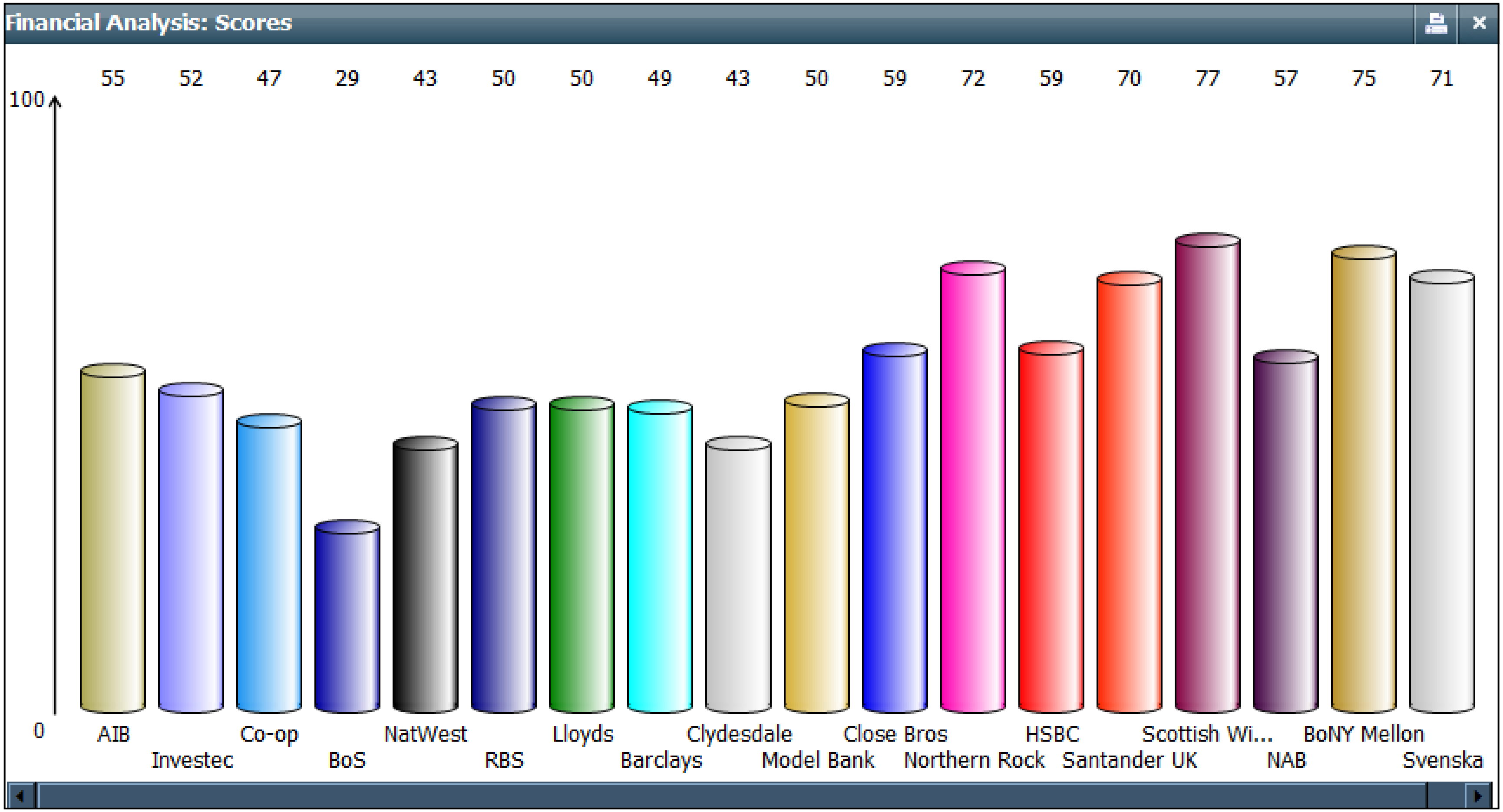
Counterparty Issues
'Overall' Risk Score



Counterparty Issues
'Credit Indicator' Risk Score



Counterparty Issues
'Financial Analysis' Risk Score



Counterparty Issues

So why are these alternatives not used in the Local Authority sector?

Appears to be due to a combination of: the "**Law of unintended consequences**" and a "**catch-22 situation**"…….

Treasury consultants interpret the CIPFA Code of Practice for Treasury Management as requiring them to monitor the ratings from all 3 main CRAs which incurs significant cost

while

Local authorities are already paying the Treasury consultants for a counterparty bank due-diligence service

Counterparty Issues
Possible Solutions?

CIPFA to amend its code of practice to allow treasury consultants to replace one of the CRAs with an appropriate alternative service that measures “other factors”

or

Scottish Councils band together and subscribe to an alternative approach on a “shared-service” basis

+

Include additional measures in the TSS to enhance the scrutiny process and allow Councils to make informed decisions with input from their Treasury consultants

Q & A Session

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