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Pay Attention To Your Cash

Three major events are on a collision course that could create the perfect storm in the world of cash. These events will hardly go unnoticed, rather they will bring about change that will alter the landscape of the cash management industry. An estimated $3 trillion will potentially change hands while looking for an alternative to the once standard parking spots in Prime Money Funds or large institutional deposits. In this paper, we will briefly explain each of the three events and their impact on the markets. We will then provide what we believe to be a viable alternative designed to provide the benefits of Prime Money Market Funds and institutional deposits while seeking more attractive yields.

Money Market Fund Reform

Perhaps the most significant change in cash markets will take place in October 2016 as the Securities and Exchange Commission (SEC) will implement regulations designed to address money market funds' susceptibility to heavy redemptions in times of stress. The most recent example was the 2008 financial crisis when some money market funds experienced a run on assets as contagion and fear set in, causing the government to temporarily prop up the cash market. The new rules state that Prime Institutional Money Market Funds must now use a floating net asset value instead of their standard perpetual $1 NAV. Additional rule changes will require funds to maintain the ability to apply liquidity fees and redemption gates, essentially freezing investors' assets, with the timing and use of such tools at the discretion of Funds.[1] These changes present obvious concerns for investors who expect Prime Money Market Funds to, at the very least, hold their initial value while providing unimpeded access to their assets.

These regulations will not apply to Government Money Market Funds, which only hold Treasuries and Agency backed short-term paper. In light of this, many Prime Funds have already begun the transition to Government Funds. However, this also poses a dilemma for some investors, as one of the main attractions of Prime Funds is the spread they can offer above Government Funds. Investors searching for incremental yield will likely be looking elsewhere.

Basel III

The crux of Basel III and other banking regulations imposed since the financial crisis is to strengthen bank balance sheets and the overall banking system. Ultimately, the goal is to limit the possibility that the government will need to "bail out" a bank in tail risk events. A key component of the new rules for banks is the Liquidity Coverage Ratio (LCR). This rule aims to ensure that a bank can meet its liquidity needs in a severe stress scenario lasting up to 30 days. The rule requires a bank to hold a sufficient amount of high quality liquid assets (HQLA) to meet expected liquidity needs (ie. run-off factor or cash outflows). HQLA are defined as low risk and easy to liquidate assets, typically in the form of very low yielding short-term Treasuries or other Central Bank deposits. In order for a bank to meet potential redemptions and maintain day-to-day operations, holding of HQLA must be greater than the assumed net cash outflows in a severe stress scenario. Basel III provides a framework to estimate these net cash outflows by addressing the likelihood of bank liabilities (deposits) to leave during stress events, known as the run-off factor. The more stable the deposit, or source of funding, the lower the run-off factor applied.

[1] *"SEC Adopts Money Market Fund Reform Rules" sec.gov July 23, 2014.*

Banks typically hold two types of institutional deposits, operational and non-operational. Basel III seeks to provide a more narrow definition of the former. Operational deposits are now defined specifically as ones used to support transactional activity; all other deposits are non-operational. Before Basel III, banks were unfettered in their implementation of this definition and could essentially label all deposits as operational. Basel III views operational deposits as a stable source of funding, and when calculating run-off factors, they are given a low probability of leaving the bank. Non-operational deposits are given a very high run-off factor because they are not tied to the banking relationship and are used by the institutional client for their liquidity needs. The more non-operational deposits held at the bank, the more HQLA the bank must hold in order to keep their LCR above 100%.

Due to the more onerous run-off factor, some banks are now charging institutions for non-operational deposits or have outright turned them away as these types of accounts are becoming unprofitable. Hence, non-operational deposits have already begun to reenter the market looking for cash management alternatives, and the amount of disintermediation is estimated to be substantial. For instance, JP Morgan reduced this type of deposit by more than $150B in 2015.[2]

Rising Interest Rates

The third catalyst for this migration is the tightening of monetary policy by the Fed. The concept of rate increases is not as complex as the prior topics; however, the timing and magnitude of the Fed actions are less certain. How the market reacts will play a strong role in the size of the cash migration.

Historically, during times of rising rates banks have been slow to increase rates paid on deposits. The slow reaction and the increased opportunity cost created by the higher interest rate environment produces retail and institutional disintermediation. With higher short-term interest rates finally returning to markets, investors and depositors may look to active cash management as an opportunity to enhance returns. Investment managers who have the skills for cash management alternatives will be poised to serve these investors.

Summary

The confluence of Money Market reforms, regulatory changes from Basel III, and rising interest rates have brought the cash markets to a major inflection point. In our view, investors will be forced to pay attention to an asset class that is often overlooked. Firms that offer cash alternatives can provide constructive strategies. With a track record of over 20 years, Fort Washington offers a flagship strategy called Ultra Short Duration as a centerpiece to such a consideration. Contact us or visit FortWashington.com for more information.

[2] *"J.P. Morgan to Increase Deposit Rates for Some Big Clients in January." Wall Street Journal December 28, 2015.*

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