NEW RISKS FOR CASH MANAGEMENT MAR 2016

DODD-FRANK & MONEY MARKET REFORM

2016: A New Era in Cash Management

In a market that has long been viewed as a bastion of low risk, liquid investment, money market and demand deposit investors have been lulled into a false sense of security. Over the years, cash management has evolved to include everything from foreign exchange, transaction banking, wire transfers and a widely used marketing term for services. For the sake of this discussion, we will use the traditional definition of cash management as the handling and usage of cash, seeking to deliver financial stability and principal protection. Since the financial crisis prompted a lengthy period of near zero interest rates combined with guarantees on deposits, cash management has been on virtual "auto pilot". However, the implementation of certain regulatory changes later this year promises to change the landscape of risk in cash management significantly.

Remnants of the Great Recession

The Great Recession of 2007-2009 led to widespread calls for change in the regulatory system. In June 2009, President Obama introduced a proposal for "sweeping overhaul of the United States' financial regulatory system," a transformation on a scale not seen since the reforms that followed the Great Depression. The bill that emerged from that proposal was the Dodd-Frank Wall Street Reform and Consumer Protection Act [1], which was signed into law on July 21, 2010. Complex and fairly large when signed, the bill was 2,300 pages, but under the agencies burdened with Dodd-Frank rulemaking, the bill has grown to over 22,000 published pages of regulatory content. At the time of this publication, the bill continues to grow, as important rules like CEO-to-worker pay ratios at public companies, still remain unfinished. This bill has made changes in the American financial regulatory environment that affect almost every part of the nation's financial services industry, including significant changes to products used by investors for cash management, which are due to take effect later this year.

A "Dollar In" Does Not Guarantee a "Dollar Out"

Money markets funds are one of the most significant financial innovations of the past century and have become a predictable mainstay of cash management since their creation in the early 1970s.

Historically, money market instruments attempted to offer a higher yield than the rates banks were offering, indirectly aided by the Federal Reserve Regulation Q, which placed a ceiling on bank deposit rates. Until Dodd Frank, money market funds were governed under SEC regulation and the Investment Company Act of 1940[2], which limits their duration and risk.

Key characteristics of the rule included a stable $1.00 net asset value (NAV), liquidity market based return, a goal of returning principal, diversification, professional asset management and economies of scale. Despite not being guaranteed or insured by a government agency or the fund sponsor, money market instruments have been perceived as having little to no risk.

Money Market Mutual Funds: Total Financial Assets

Source: Board of Governors of the Federal Reserve System (US); FRED

There are two instances in the 40-year history of the money market instrument that foreshadowed the regulatory changes that go into effect later this year. The first, "breaking of the buck" happened in 1994, when Denver-based Community Bankers U.S. Government Money Market reported an NAV below $1.00. The second occurred during the Great Recession, when the Reserve Primary Fund came under major financial distress and could not return the required $1.00 per share.

Because of the Reserve Fund "breaking the buck," and the requirements of systemic risk, the Securities and Exchange Commission (SEC) was forced to make significant changes to money market rules under the Investment Company Act of 1940. On July 23, 2014, the SEC voted to make amendments of two principal reforms:

- **Institutional prime & municipal bond money market funds will be required to float their net asset values (NAV) under fair value pricing.**
- **All money market funds will be permitted to, and under some circumstances required to, impose liquidity fees and gates against investor redemptions, which impose financial repercussions on withdrawals during periods of distress.**

Additionally, the amendments modify other requirements, including provisions [3] relating to suspensions of redemptions, which are designed to keep investors from rapidly withdrawing funds during times of economic turmoil. The one key exemption to these reforms pertains to U.S. Government funds which will be allowed to continue with a stable NAV.

These amendments could cause a major shift in the amount of cash invested in money market funds. As these provisions become more widely grasped, it is generally expected that redemptions will result. Both institutional and retail money market funds are significant buyers of commercial paper and other types of short-term debt securities. As money market redemptions occur and subsequent demand for commercial paper or short-term debt securities wanes, the banks and other companies that issue these debt instruments could see their costs rise dramatically.

Bank Deposits

As Washington claimed no institutions were "Too Big to Fail", one major provision of the Dodd-Frank bill attempts to ensure that the *too big to fail* financial institutions will not need another taxpayer bail-out in the future. The provision is Title II which makes the FDIC responsible for handling the orderly liquidation of banks that are close to failing. Title II provides an alternative to bankruptcy, in which the FDIC is appointed as a receiver to carry out the liquidation of the company. The purpose of this provision is aimed at protecting the financial stability of the American economy, forcing shareholders and creditors to bear the losses of the failed financial company, removing management responsible for the financial condition of the company, and ensuring that payout to claimants is at least as much as the claimants would have received under a bankruptcy liquidation [5].

In the United States, the Federal Deposit Insurance Corporation (FDIC) with the full faith and credit of the US government, provides deposit insurance that guarantees the deposits of member banks up to $250,000 per depositor, per bank.

Total Savings Deposits at All Depository Institutions

Source: Board of Governors of the Federal Reserve System (US) FRED

It is widely understood that the account holder of a bank deposit has the right to withdraw their funds per the terms and conditions of the account. However, what is often not realized by the depositor is that when a person or entity makes a deposit in the bank, the account holder surrenders legal title to his or her cash.

The deposit becomes a liability on the banks balance sheet, and the bank considers this an unsecured debt. The depositor is essentially a creditor to the bank. Should a bank come close to insolvency, under the new Dodd-Frank provisions, those liabilities can be converted into equity in order to promptly re-capitalize.

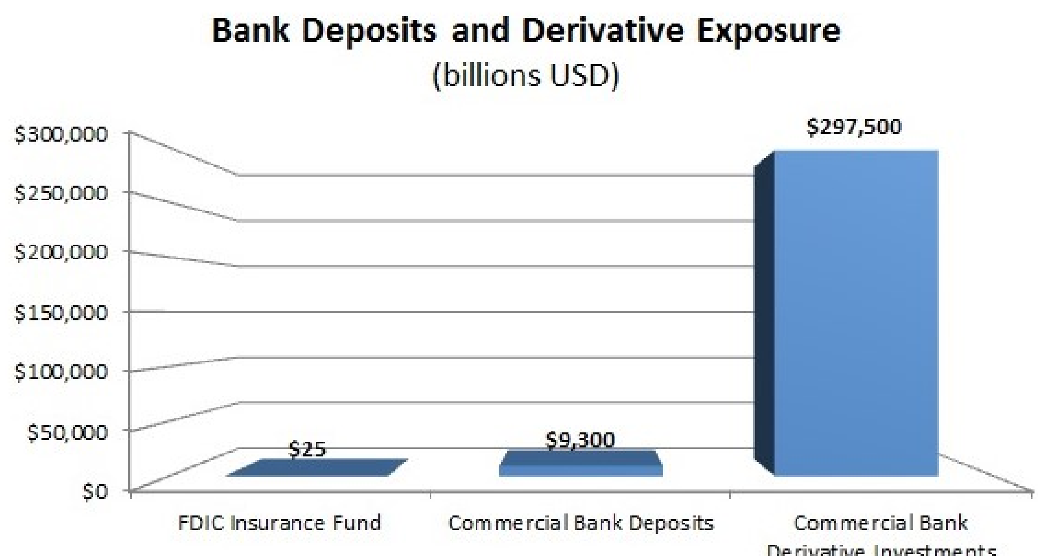
The New Rules in Bank Deposits: Dodd- Frank "Bail-In" Provision

The Dodd- Frank "Bail In" provision authorizes the FDIC to re-capitalize failed financial institutions by using depositors' funds. The new rule essentially restructures the banking system so that creditor funds will be used to support the business of a bank in default, and this will now include the use of uninsured deposits (over FDIC limits) to recapitalize banks in the event of a collapse. Skeptics of this policy suggest that this is not fair to depositors. However, unsecured creditors in all areas of business face similar claim structures, and depositors surrender the legal title to their cash when they make that deposit.

A major reason that the "Bail-In" provision could be an issue is that many large banks have been accused of commingling their derivative portfolios with their depository holdings. Under current rules, this is allowed because derivatives also fall under the liability side of the balance sheet. What is not widely understood is whether insurance funds (FDIC) would be diverted towards derivatives that have left the bank on the brink of bankruptcy. Under the Bankruptcy Reform Act of 2005, derivatives counterparties were given preference over all other creditors and customers of the bankrupt financial institution in question over FDIC insured depositors.

As of October 2015, the FDIC announced [4] it had adopted a proposal to increase the Deposit Insurance Fund (DIF) to a required minimum level of 1.35 percent of deposits (this does not include derivatives) by September 30, 2020 [6]. For perspective, if you add JP Morgan and Bank of America's deposits they total over a trillion dollars, while the DIF at the FDIC at the end of 2015 was less than 40 billion dollars.

Depositors whose balances remain below the FDIC threshold are not at risk, as long as the FDIC has the money to cover the deposit claim or can source the appropriate funds. However, it is important for those depositors who have money over the $250,000 FDIC limit, to be aware of the "bail in" provision and understand their counterparty risk at the institutions in which they have deposits.



Source: Federal Reserve June 2015

Balancing Liquidity Risk/ Reward

As markets begin to reflect the full effects of Dodd-Frank, the money market reforms, and bank bail-in provisions, no longer can investors deposit cash and "forget it". We suggest the following two part strategy in an effort to preserve liquidity and protect principal, customizable for the time horizon best suited to each individual client.

Daily Deposits: Liquid cash investors will need to be cognizant of keeping deposits under the FDIC limit of $250,000 or diversifying between FDIC sweep programs that internally diversify amongst banks or those with higher FDIC limits.

Short Duration Managed Portfolio: Investors looking for additional yield and principal protection may want to consider a short duration municipal bond portfolio laddered to meet future cash needs. APA's Short Duration strategy provides an alternative approach for money market investors to seek enhanced returns, capital preservation, and a high level of liquidity. Short duration municipal bond portfolios generally offer investors higher yield than daily cash accounts and in a low interest rate environment, every little bit helps.

For more information about Asset Preservation Advisors customized portfolio management, please contact:

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173)
[2] Investment Company Act of 1940 (CFR 270.2a-7)
[3] Investment Company Act of 1940 (CFR 270. 22e-3)
[4] October 22, 2015 Federal Deposit Insurance Corporation press release
[5] Source Richmond Federal Reserve & Cornell University Law School "Dodd-Frank: Title II– Orderly Liquidation Authority"; www.law.cornell..edu/wex/dodd-frank_titel_II
[6] Source Federal Deposit Insurance Corporation press release

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