Potential Regulatory Changes Cloud Outlook at Front End of Yield Curve

By Randy Myers

The front end of the yield curve—home to conservative investments such as money market funds, short-term investment funds (STIFs), and even stable value—has been challenging for the past few years, not just for individual investors, but for institutions as well, including corporate sponsors of defined contribution plans. Corporations have record amounts of cash on their balance sheets, but the yields available to them at the front end of the curve have been languishing at or near historic lows. Meanwhile, proposed regulatory reforms could soon change the way money market funds operate.

"People are struggling with what's going on," Laurie Brignac, senior portfolio manager and co-head of North American Global Liquidity for Invesco Fixed Income, said at the 2013 SVIA Fall Forum. "Where do you put your money? Corporate treasurers are asking us all the time, 'What's the next step?'"

The answers aren't entirely clear. The Federal Reserve has indicated that it plans to keep short-term interest rates at extraordinarily low levels until unemployment falls to 6.5 percent, which many economists don't anticipate happening until late 2014 or early 2015. But there are some bright spots on the horizon, Brignac said.

Perhaps most intriguingly, the Fed announced in September that it is going to start testing a new tool—fixed-rate, full allotment, overnight reverse repo facilities—that should help establish a floor on money market rates. And the U.S. Treasury, Brignac noted, has announced that it will hold its first floating-rate note auction in January 2014, creating securities that could provide extra yield to investors when interest rates move higher.

"In this low-rate environment, everybody is pushing for yield and looking for new places to invest money," Brignac said. "We're seeing a lot of clients max out as much as they can in money market funds, but where are they putting (the excess)? We're getting record requests for separately managed accounts."

From the left: Stephen Kolocotronis, Fidelity Investments; Laurie Brignac, Invesco; Gina Mitchell, SVIA; Timothy Keehan, American Bankers Association

Meanwhile, government regulators are considering changes in the way money market funds operate, particularly with respect to maintaining a constant net asset value of $1 per share. As Brignac explained, the Securities and Exchange Commission has proposed three alternative approaches. In the first, institutional prime money market funds and tax-exempt money market funds would have to allow their net asset values to float daily with market values, out to four decimal places, rather than hold constant, as is currently done. Government funds and funds catering to retail investors would be exempt from the change. Proponents argue that a floating NAV would give institutional investors a truer picture of the value of their money market holdings. "It sounds deceptively

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presidential elections. Republican supporters, by contrast, are dispersed more widely across the country, giving the GOP more of an advantage in House elections. Both George W. Bush in 2004 and Barack Obama in 2012 won the popular vote for the presidency, Barone noted, but Obama got many more electoral votes in his race. It was the opposite story in the House, he said, with Bush carrying 225 Congressional districts but Obama only 209.

Despite all that has happened, Barone said he thinks Democrats will face an uphill battle to regain the House in 2014, noting that only 17 Republican House districts were carried by Obama in 2012.

"Blame the government shutdown on the incompetence of both parties, but spare some blame for the framers of the Constitution and the American people as well," he concluded. "We have met the enemy, and he is us." SVIA

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simple," cautioned Brignac, arguing that it would, in fact, represent a very big shift for the money market industry, with challenges around recordkeeping on the part of buyers, sellers and intermediaries.

Stephen Kolocotronis, Fidelity Investments and Chair of the SVIA Government Relations Committee

A second alternative proposed by the SEC would keep stable net asset values for money market funds but create liquidity fees and redemption gates that would kick in if funds sustained substantial losses. Yet a third alternative would blend the first two approaches.

On an unrelated front, Brignac said, the SEC also is reviewing comments right now on a separate proposal that would require enhanced stress testing by money market funds, something she said the industry could easily handle.

While they are still looking at money market reform, regulators have already issued new rules for Short Term Investment Funds (STIFs), which are collective investment funds operated by banks. Like money market funds, they invest in short-term, high-quality, low-risk, fixed-income securities. Unlike money market funds, STIFs are available only to a bank's fiduciary customers, such as personal trusts and employee benefit plans, said Tim Keehan, vice president and senior counsel at the American Bankers Association's Center for Securities, Trusts and Investments. Also unlike money market funds, STIFs are not sold directly, but are typically provided as a component of another bank service. STIFs can serve, for example, as a sweep vehicle for the cash balance of another bank-maintained collective fund.

In July 2013, STIFs became subject to new rules issued by the Office of the Comptroller of the Currency. The rules are aimed at preventing any loss of principal in STIFs. Among other things, they require OCC-regulated banks to set and monitor limits on portfolio quality and diversification, stress test their portfolios at least monthly, and provide monthly disclosures about their portfolios to both fund participants and the OCC. The process has proved largely manual rather than automated, Keehan noted, requiring input from many departments within the banks that offer STIFs.

If the SEC goes forward with its proposed money market reforms, Keehan said the OCC may revisit its regulations for STIFs and consider whether more are needed.

Regulatory changes with STIFs and money market funds may make stable value even more of a go-to fund for retirement plan participants and plan sponsors looking for capital preservation as well as predictable, positive returns. However, even stable value was touched by the Dodd-Frank Act of 2010, despite its stellar performance in the financial crisis. Stable value was swept into Dodd-Frank's call for tighter oversight of derivatives, or what the Act calls "swaps," even though it seemed clear that legislators recognized that stable value was not a swap. As SVIA President Gina Mitchell pointed out, legislators simply ran out of time to change the bill's language, and were afraid that if they carved out stable value investment contracts, they would be overrun with other product requests. Instead, SVIA was able to achieve something no other group did: an exemption that required the CFTC and SEC to take a deliberative and thorough review of stable value investment contracts to determine if stable value was a swap, and if the Commissions determined stable value was a swap, whether it was in the public interest to exempt them from regulation as a swap. She noted that the Commissions have requested information from the public twice and have not yet completed their study of the subject. Even if they conclude that stable value contracts are swaps—a view the SVIA has contested—the regulators have the authority under Dodd-Frank to exempt stable value contracts from the new regulations. Until a final decision, the Act provides certainty that all stable value contracts are not swaps. SVIA

Wells Fargo Economist Sees US Consumer Spending in Seventh Inning of Rebound

By Randy Myers

The U.S. still hasn't recovered fully from the Great Recession of 2008-2009, but it's getting closer.

Jay Bryson, managing director and global economist for Wells Fargo, told participants at the 2013 SVIA Fall Forum that he foresees real U.S. gross domestic product growing by about 2.5 percent in 2014 and 2.75 percent in 2015. That would be down from the 3.2 percent growth rate averaged from 1992 through 2007, but up from the 2 percent or so averaged over the past few years. In short, it's sluggish but improving.

A key component of that forecast, Bryson says, is his expectation that consumer spending, which accounts for about two-thirds of GDP, will continue to gradually grow as well. Stronger gains in consumer spending would translate into stronger economic growth, of course, but several factors are working against that, Bryson said. Although many Americans have successfully deleveraged their personal balance sheets—shrunk their debt, in other words—relatively few are showing any sign of wanting to leverage up again. While more have been willing to take on car loans, the biggest driver of non-revolving credit over the last few years has been student loans. "That's not a sign that people want to leverage up, but that they are desperate to improve their earnings power," he said. In terms of consumers deleveraging, he said, "my sense is that we're in the seventh inning,"

The biggest potential for better-than-expected economic growth, Bryson suggested, lies in the chance that Americans begin saving less and spending more. But he said that isn't likely to happen

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