Lesson from America

DO TREASURERS IN THE US AND EUROPE MANAGE THEIR CASH DIFFERENTLY? WHEN IT COMES TO MMFs, THE ANSWER IS USUALLY "YES", SAYS ANTHONY CARFANG

Money market funds (MMFs) are widely used by corporate treasurers to manage short-term cash. There are fundamental differences in how they are used by treasurers in the US and in Europe, however. Some of these differences arise from variances in the banking and capital markets between the two regions. Others are a function of historical evolution. As regulators continue their efforts to restrict the usage of MMFs, it is helpful to examine the part they play in investment strategies.

Types of cash

Within our corporate consulting practice, Treasury Strategies has a framework that separates cash into four distinct categories:

- **Operating cash** – very short-term horizon, payroll to payroll. This is almost exclusively invested in MMFs and bank deposits.
- **Reserve cash** – the extra cushion needed over the business cycle. These funds are invested in MMFs, bank deposits and other high-quality short-term instruments.
- **Accumulation cash** – large portfolios, usually in concert with a strategic corporate event. These portfolios take on a little more credit risk and are invested for longer maturities. Often, they include an outside manager.
- **Stranded cash** – cash required by regulation or custom such as escrows, security deposits, performance bonds, etc. Generally, the investments are subject to statutory restrictions.

Comparison between the US and Europe

It is with regards to the operating cash and reserve cash pools that US and European treasurers differ. US treasurers are far more inclined to invest in MMFs, while European treasurers are more reliant on bank deposits.

In the US, institutional funds (those most likely to be used by treasurers) have total assets of $1.2 trillion. Funds represented by the Institutional Money Market Funds Association (IMMFA), the closest comparable category in Europe, have total assets worth less than €600bn. Yet the relative GDP in Europe is greater than US GDP.

According to our research and experience, more than 75% of US companies have used MMFs for liquidity management. Roughly 40% of US corporate cash is invested in MMFs. In contrast, fewer than 50% of European companies have used MMFs. These funds comprise only 25% of total corporate cash in the region.

A US treasurer is more likely to use a combination of MMFs and bank deposits for operating and reserve cash. In Europe, there is a greater emphasis on bank deposits.

EXAMPLES OF INNOVATIVE CORPORATE USE OF MMFS

Joint ventures

One of our clients, a global infrastructure firm, conducts most of its construction projects as joint ventures with local construction firms. At any given time, it operates more than 2,000 joint ventures. Each has its own cash pool, with balances ranging from a couple of thousand up to several million dollars. In aggregate, its cash exceeds $2bn and, since the individual pools cannot be co-mingled, most of the cash was un-invested. At best, the larger joint ventures received minimal interest from local banks.

To solve this problem, we helped the company establish its own money market mutual fund and registered it with the Securities and Exchange Commission. Each joint venture was able to sweep cash into its own wholly owned, indivisible shares of the new corporate MMF. As a result, corporate treasury was able to centralise and efficiently manage its $2bn cash pool.

Counterparty risk management

A multi-subsidiary consumer products company managed its considerable cash pool at the subsidiary level. Generally, the subsidiaries maintained half their cash in bank accounts and the other half was invested in a short-term commercial paper.

The company's treasurer was concerned about a serious lack of diversification and hence a concentration of credit risk. Eight of the nine subsidiaries kept most of their deposits in the same three banks. In addition, their commercial paper investments were concentrated in just six banks, including the three bank depositories.

By revising its banking and investment policies to include MMFs, the company was able to significantly reduce its counterparty exposure. Bank deposits were limited to the greater of 30% of each subsidiary's cash pool or two weeks' cash flow. The direct commercial paper was eliminated with the remainder of the pool invested in prime MMFs. These funds, by virtue of their commercial paper investments in more than 100 banks, provided the necessary diversification.

Interestingly, management of the accumulation of cash is quite similar on both sides of the Atlantic. Because these pools are larger and have a more protracted horizon, treasurers are comfortable taking on more credit risk and investing in longer maturities. Frequently, an outside manager is involved.

Fund structure in the US

In the US, there is only one type of MMF. All MMFs follow the Securities and Exchange Commission's (SEC's) Rule 2a-7. This rule enables MMFs to provide daily liquidity at par by, among other things, limiting portfolio maturities and credit exposure, requiring extensive diversification and allowing amortised cost accounting. As a result, there is only one type of fund and its elements are well understood by the market participants. Within the construct of 2a-7, funds only differ according to their investment objective. The three major types are government and treasury funds, tax-exempt funds and prime funds.

This standardisation, which took place more than 30 years ago, led to the widespread adoption of MMFs as the liquidity instrument of choice for corporate treasurers. Standardisation gave technology companies a head start in designing and implementing corporate treasury software. It enabled banks, early on, to automate a variety of cash management and sweep services. As a result, MMFs became entrenched as a key liquidity tool, which their growth demonstrates.

Fund structure in Europe

In Europe, treasurers do not enjoy such simplicity. There are MMFs and short-term MMFs. There are constant net asset value (NAV) funds and, in a couple of countries, fluctuating NAV funds. There are dividend shares and accumulating shares. Key attributes such as permissible maturity structures, liquidity requirements, credit quality, governance and accounting rules differ by jurisdiction.

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This complexity has slowed the acceptance of MMFs across Europe. To its credit, IMMFA provides a degree of standardisation. Indeed, IMMFA funds have grown at an impressive rate over the past decade.

MMFs and the financial crisis

During the 2007-8 financial crisis, markets around the world froze. In mid 2007, the asset-backed commercial market hit a wall. Late 2007 saw losses and wind-downs in enhanced cash funds. In early 2008, the auction-rate securities market froze. As a result, corporate treasurers exited each of these tainted asset classes, moving even more corporate cash into MMFs as the last refuge. By September 2008, the failures of Fannie Mae, Freddie Mac, Lehman Brothers, Washington Mutual and HBOS – all within a few days of each other – caused investors to flee all risk assets.

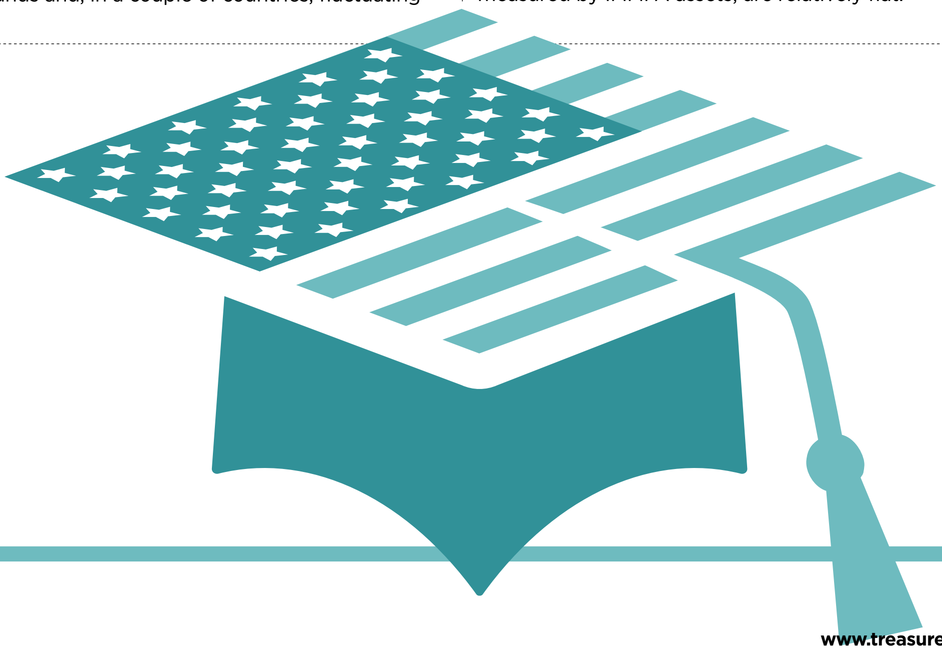
MMFs were not immune. Treasurers switched out of prime MMFs and into treasury funds. Over time, as the scope of government deposit insurance programmes was expanded, many treasurers reduced their MMF holdings in favour of bank deposits. Since 2008, US MMF assets are down by about a third while European funds, as measured by IMMFA assets, are relatively flat.

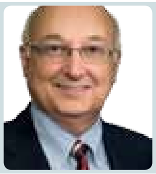
Where are we today?

Ideas put on the table by regulators in both the US and Europe will impair the value of MMFs for corporate treasurers. Some of the proposals will render these funds useless. Although virtually every other non-government liquidity instrument failed prior to the MMF industry becoming stressed, regulators seem determined to more tightly regulate MMFs, almost to the point of extinction.

For 40 years, MMFs have been reliably providing corporate treasurers with daily liquidity at par and low risk. Adoption was initially greater among US treasurers, in part because of the standardisation established by SEC Rule 2a-7 and in part because of onerous legal restrictions on US banks, for example, prohibiting them from offering branch banking across state lines. More recently, MMFs have begun to play a more prominent role in European treasurers' investment strategies, largely due to the standardisation provided by IMMFA.

As we go to press, we are uncertain of the specific regulatory outcomes affecting MMFs. We do know that corporate treasurers in both the US and Europe are increasingly vocal, however. Our work in both regions suggests that under the most frequently leaked proposals, corporate treasurers will exit MMFs in favour of bank deposits.





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