Liquidity Investment Challenges

Executive summary

- The landscape for liquidity investors has changed dramatically in the years since the financial crisis.
- These changes have been brought about through three main developments: stricter banking regulation, money market regulatory reforms and changing supply/demand dynamics.
- As a result of the changes in the liquidity investing landscape, money market yields are extremely low and investors may need to re-evaluate the tradeoffs between quality, maturity and yield associated with managing liquid assets.
- Exhibit 1 illustrates some of the tradeoffs in the European market. For example, European investors seeking AAA credit quality and a positive yield may need to take on maturities well beyond the money market universe, as German sovereign bond yields are negative at maturities of less than three years.
- Alternatively, investors seeking a positive yield and overnight liquidity may need to take a different degree of credit risk than in the past, as overnight maturities are generally negative on European assets rated BBB or better.
- Considering the tradeoffs in today’s environment, investors may benefit from re-evaluating their liquidity needs with the recognition that high quality, overnight liquidity now comes at a cost.

EXHIBIT 1: THE EURO ZERO LINE
Combination of credit quality and maturity required to achieve a positive yield

![Graph illustrating the relationship between credit quality, maturity, and yield](image)

Bullets indicate the tenor at which yield turns positive:
- AAA-rated Sovereign issuer (e.g. Germany)
- AAA-rated Agency issuer (e.g. FMS Wertmanagement)
- AA-rated Sovereign issuer (e.g. France)
- AA-rated commercial paper issuer (e.g. Rabobank)
- A-rated Sovereign issuer (e.g. Ireland)
- A-rated commercial paper issuer (e.g. Natixis)
- BBB-rated Sovereign issuer (e.g. Italy)
- BBB-rated commercial paper (e.g. BBVA)

Source: GSAM. As of 10-September-14. For illustrative purposes only. Bullets indicate tenor at which yield turns positive.
Liquidity Investing Challenges

Liquidity investing: At the nexus of banking and money market reforms

For many years prior to the financial crisis that began in 2008, money market funds offered investors three main benefits: high credit quality, liquidity and yield. However, in the years since the crisis, liquidity investing has been at the nexus of massive changes in regulation. On one side, stricter banking regulation has significantly reduced the ability and willingness of financial institutions to participate in money markets. On the other side, money market funds are subject to new regulations in the US and pending regulatory changes in Europe that are transforming the market.

Regulatory changes and other factors have contributed to significant imbalance in the supply/demand dynamics of liquidity investing. This imbalance has played an important role in pushing yields on many traditional money market investments into negative territory. As a result, investors in today’s markets will find it increasingly challenging to achieve all three traditional benefits of the money markets. Maintaining liquidity and credit quality now comes at a cost, in the form of negative yields.

Banking regulations

Banking regulations are becoming both stricter and more encompassing, with new regulations being applied across all financial institutions in all areas. The liquidity crisis of 2008 alerted financial industry regulators to the need for an enhanced and robust liquidity and risk framework in order to help prevent a similar global financial crisis from occurring again. As a result, in December 2010, the Basel Committee on Banking Supervision issued Basel III: International framework for liquidity risk measurement, standards and monitoring. Basel III introduced two key measures designed to ensure that financial institutions have adequate amounts of liquidity. In addition, certain US banks must adhere to a Supplementary Leverage Ratio (SLR), which raises the cost of low margin business and low risk assets.

| EXHIBIT 2: KEY BANKING REGULATORY CHANGES AND THEIR POTENTIAL IMPACT ON MONEY MARKETS |
|-----------------------------------------------|--------------------------------------------------|-----------------------------------------------|--------------------------------------------------|
| Change                                         | Money Market Impact                              | Change                                         | Money Market Impact                              |
| Liquidity Coverage Ratio (LCR)                 | Banks will be required to hold high-quality liquid assets to cover the amount of bank liabilities that might run in a 30-day stressed period | Increases bank demand for high-quality, liquid assets |
| Net Stable Funding Ratio (NSFR)                | Banks are required to hold more deposits and reduce short-term wholesale funding, making them fund their activities with more stable sources of funding | Reduces supply of short-term bank commercial paper in the money markets |
| Supplementary Leverage Ratio (SLR)             | Raises banks’ cost of holding deposits and low-risk assets | Reduces banks’ willingness to take time deposits |
| Source: GSAM                                   |                                                   |                                               |

Money market reforms

After many years, we finally have clarity regarding the new requirements for money market funds and a specific implementation timeline in the US, while money market reform remains on the legislative agenda in Europe. In some respect, this event is momentous in that it follows a long period of anticipation and debate. In other respects, it is just another step in the evolution of liquidity markets that have been changing over the past several years (Exhibit 3).

The new rules will delineate different requirements based on fund type and investor type. The rules introduce a new concept to mutual funds: different fund features based on the type of investor, namely a designation between “retail funds” and “institutional funds.”

■ **Retail Funds**: A retail money market fund would be defined as a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the money market fund to natural persons.

■ **Institutional Funds**: An institutional money market fund would be defined as a money market fund that does not meet the definition of a retail fund (i.e., all other fund investor types).
In terms of the new requirements for the different types of funds, the rules fall into four primary categories:

1. Floating NAV;
2. Liquidity Fees and Redemption Gates;
3. Enhanced Disclosure and Reporting Requirements; and

Further details are contained within our paper published in August 2014, "SEC Approves Long-Anticipated Changes to Money Market Fund Rules".

With the increased regulation of the short-term markets, we believe that liquidity investors looking for stability, liquidity, and yield will have to choose the relative priority of those goals and assess their liquidity needs in light of an expanding set of investment solutions.

While the investments and risk profile of money market funds are not changing with these new requirements, we recognise that the new structural features could require significant additional analysis and logistical collaboration within organisations affecting legal, accounting, and other business partners.

To that end, we are committed to working with our clients to understand their own implementation implications, find ways to analyse and assess the viability of investment options in this new environment, and provide alternative solutions to the extent money market funds will have different utility in the future.

EXHIBIT 3: EXPECTED TIMELINE OF BANKING AND MONEY MARKET REGULATORY CHANGES

Mismatched supply / demand dynamics

One important goal of stricter banking regulation is to ensure that a financial institution can overcome any short-term liquidity disruption. However, in money markets, this has had the effect of sharply reducing the available supply. Since financial institutions are required to hold a certain level of highly-liquid assets, they are less able to lend out short-term debt, thus decreasing the supply of Commercial Paper, Time Deposits and Repurchase agreements -- securities that form the bedrock of money market fund investing.
Liquidity Investing Challenges

EXHIBIT 4: THE SUPPLY OF SHORT-TERM COMMERCIAL DEBT HAS FALLEN SHARPLY...
Net issuance of commercial paper (CP), asset-backed commercial paper (ABCP) and unsecured CP

Source: Dealogic CPWare. As of November 2014

While the supply of short dated assets has declined, the same cannot be said about the demand for these assets. Money market funds, although down from their peak assets in ’09 remain a healthy consumer of these securities. This demand is compounded as corporations continue to hold record levels of cash and cash equivalents on their balance sheets -- over $1.5tn as of September 2014, according to Bloomberg.

EXHIBIT 5: …WHILE DEMAND FOR SHORT-TERM DEBT REMAINS STRONG
Assets invested in money market funds (“MMF”)

Source: Bloomberg, IMoneyNet. As of November 2014.

The imbalance in money market supply and demand is at the heart of the challenges facing liquidity investors. With continued strong demand for liquid assets in an environment of declining supply, yields on money market assets have fallen to very low levels and many now have negative yields.

Meeting the challenge

We believe one way investors can address the challenges of low or negative yields on highly liquid assets is to reevaluate the way they manage liquidity. In many cases, when we work with investors to assess their liquidity needs relative to their liquidity investment strategy, we find too much emphasis on overnight liquidity.

We believe a more efficient approach is to divide cash needs into three main categories of liquidity and invest in securities that are best suited for each category (Exhibit 6).

EXHIBIT 6: TIERING LIQUIDITY INVESTMENTS TO MEET OBJECTIVES
## Conclusion

With liquidity investors being buffeted by regulatory and market headwinds, it’s no surprise that they are looking to asset managers to partner with them to help navigate these challenges. Our goal is to partner and advise you to ensure that we are offering the right solution that caters to your exacting needs in this changing liquidity market landscape.

As investors balance the desire for principal stability, liquidity, and yield, it is important to remember that today’s market imposes greater limitations on these facets. Ongoing financial regulations have caused a significant reduction in the supply of short-dated securities, while demand for these securities, be it from the money market fund industry or from corporates looking to purchase directly, has not diminished.

Additionally as financial regulations begin to limit the supply, we believe that size of assets under management will matter, and to this respect as one of the largest offshore money market providers we believe we will be in a preferred position as financial institutions will only wish to transact with larger institutions.
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