UBS

Liquidity Perspectives—2Q16

Regulatory changes are coming: what they mean for institutional cash managers

Beyond "breaking the buck"

- Following the 2008 financial crisis, **regulators recognized that a new framework was needed** to make banks and **money market funds more resilient and better at managing risk**.
- Subsequently, the **SEC amended rules governing money market funds** that will be fully implemented by October 2016. The reforms are intended to:
  - **Increase the transparency** of risks associated with money market funds.
  - **Protect investors** from mass redemptions in times of crisis by imposing liquidity fees and/or gates on redemptions under certain circumstances.
  - **Reduce ambiguity** with website disclosures and more detailed regulatory filings.
- Corporate treasurers face new challenges given the evolving regulatory environment. Along with tax, accounting, liquidity and yield implications of money market reforms, they must also consider increased bank regulations such as Basel III Liquidity and Capital ("Basel III") requirements that may lead banks to accepting fewer deposits. As a result, corporate treasurers may need to reconsider how cash is distributed among various investment counterparts.

What's behind the regulatory changes?

The 2008 financial crisis raised serious questions about the financial system's ability to handle shocks. As the crisis intensified, the U.S. Treasury, the Federal Reserve and other agencies intervened to support certain financial institutions that lacked capital to absorb losses related to a collapsing housing market and to provide liquidity to meet their short-term obligations. Despite this intervention, the ripple effects were felt across other parts of the market, including what were perceived as "low-risk" investment vehicles such as money market mutual funds. As a result of these structural shortcomings, regulators introduced an unprecedented number of regulatory initiatives aimed at improving the financial system's ability to absorb shocks, manage risk, and strengthen transparency and disclosure. Several of these reforms become effective in 2016, including those governing money market funds.

Key changes affecting cash management

When developing a new framework, regulators wanted to ensure that banks would be adequately capitalized in case of potential stress by installing strong liquidity and capital safeguards. But perhaps more than any other change, the new Basel III liquidity requirements are having a significant impact on how banks operate. That is because banks now have two types of deposits to deal with: operating and non-operating. Non-operating deposits, or balances above those needed to make daily payments, are considered less stable and must be invested in high-quality liquid assets, which have lower returns. These returns are further penalized by the banks' requirement to hold more capital. As a result, corporate treasurers now need a better understanding of how banks view their balances so they can manage cash levels accordingly or face earning significantly lower returns on their deposits.

Some large banks are asking corporate clients to accept low or negative returns on deposits.

Regulatory changes affecting corporate treasurers aren't limited to bank deposits. Regulators have also focused their attention on money market funds. Building on the reforms adopted in 2010, the SEC has developed a new framework that will come into full effect in October 2016. The introduction of a floating net asset value (FNAV) for institutional prime and municipal money market funds is one key development for corporate treasurers.

Most professional investors are aware that with the introduction of FNAV pricing, institutional prime and municipal money market funds will no longer be able to use the "amortized cost" and/or "penny rounding" method of pricing. Instead, basis-point rounding will be used (rounding to the nearest 1/100th of 1%, or the fourth decimal place in the case of a fund with a $1.0000 share price). This implies that shares of money market funds may fluctuate and could better reflect potential risks associated with these investments.

In addition to FNAV pricing, the SEC's amended rules give money market fund boards the ability to impose liquidity fees and/or gates on redemptions ("gates and/or fees") under certain circumstances to protect investors. If a fund's weekly liquid assets fall below 30%, fund boards have the option to either impose fees of up to 2% and/or halt redemptions for up to 10 business days. Should weekly liquidity fall below 10%, boards are required to impose a 1% fee, unless they determine it is not in the interest of the fund.

It is important to note that FNAV is only applicable to institutional prime and municipal funds. Retail money market funds (i.e. funds that seek to limit all beneficial owners to natural persons) and government money market funds will be permitted to continue to seek to transact on a constant NAV basis. With regard to gates and fees, only government money market funds are exempt.

Implications of money fund reforms

The combination of Basel III and money market reforms is challenging corporate treasurers to reconsider the distribution of cash across various investment vehicles and counterparties. To strike the right balance, it is crucial for treasurers to understand how money market fund reforms will affect taxes, accounting, liquidity and yields. The following is a summary of such potential impacts:

- **Tax implications**
  Institutional prime and municipal money market funds are required to move from a stable $1.00 share price to valuing their portfolio securities at market value and to sell and redeem shares based on FNAV pricing. As a result, the sale of shares could result in gains and losses, which are taxable events. According to guidance from the US Department of Treasury and the Internal Revenue Service, investors in FNAV money market funds will be able to report a single net number for realized gains and losses over the course of a year, rather than reporting individual transactions.

- **Accounting implications**
  Investors may have debt covenants that mandate certain levels of cash and cash equivalents. Under US GAAP, FNAV money market funds will still be considered a "cash equivalent" unless a fund's gates and/or fees have been triggered.

- **Liquidity implications of gates and fees**
  Institutional prime and municipal funds will normally price their shares daily and settle the same day, effectively allowing investors access to daily liquidity. However, given the possibility that gates may be introduced to institutional prime or municipal money market funds in times of stress, access to these funds may be halted for up to 10 days. (Although not required, government money market fund boards are permitted to impose gates and/or fees if disclosed to investors in advance; however, most such funds are not expected to opt into such arrangements.)

- **Yield implications**
  Prime funds typically earn a spread over government funds. Government funds may become more popular because they are not required to adopt FNAV pricing and are exempt from required gates and/or fees. In response, most fund complexes have announced or implemented plans to convert certain prime funds to government funds. Given these dynamics, along with limited supply of short-term government securities, the gap between yields offered by prime and government funds may increase.

Basel III is challenging corporate treasurers to reconsider the distribution of cash across various investment vehicles and counterparties.

What corporate treasurers need to know:
- Investors in FNAV money market funds will be able to report a single net number for realized gains and losses. This will help mitigate tax burden.
- FNAV money market funds will still be considered a "cash equivalent" under normal circumstances.
- Given the possibility that gates may be introduced for prime and municipal funds, access to funds may be halted for up to 10 days.
- Since government funds are exempt from the most significant changes, demand for these funds may increase relative to prime and municipal funds.
- The gap between yields offered by prime and government funds may increase.

To help guide investment decisions, the following chart outlines certain key features of the various options for cash investments once the October 2016 changes become effective:

	Features	Advantages	Considerations
Prime Funds	• Shares are valued at floating NAV. • Possible gates and/or fees on redemptions. • Income and capital gain distributions are taxable. • Gains realized upon sale of fund shares are also taxable. • Normally qualify as "cash equivalent" for accounting purposes.	• Daily liquidity under normal circumstances. • Potentially higher yields than government funds and other overnight investments such as bank deposits.	• Possibility for imposition of gates and/or fees in a stressed situation. • Possible gains and losses due to floating NAV.
Municipal Funds	• Shares are valued at floating NAV. • Possible gates and/or fees on redemptions. • Income distributions are generally exempt from federal, and in some cases state, income taxes; capital gains are taxable. • Gains realized upon sale of fund shares are also taxable. • Normally qualify as "cash equivalent" for accounting purposes.	• Daily liquidity under normal circumstances. • Potential for tax efficient income.	• Possibility for imposition of gates and/or fees in a stressed situation. • Possible gains and losses due to floating NAV.
Government Funds	• Shares attempt to maintain a constant NAV. • No gates or fees on redemptions. • Income and capital gain distributions are taxable. • Normally considered "cash equivalent."	• Daily liquidity under normal circumstances. • Increased safety due to exposure to government securities and related repos.	• Demand for government funds is expected to increase given regulatory positioning, which may increase the spread relative to yields earned on prime funds.
Separately Managed Accounts	• Investments are marked to market. • No gates or fees on redemptions. • Income/gains are taxable. • Considered "short-term investments."	• Complete ownership of securities. • Ability to customize investments and create specific tax consequences. • Potential to generate returns higher than money market funds and deposits.	• Less liquid than money market funds and, depending on the securities owned, may take at least three to five business days to redeem. • Higher credit risk than money market funds.

The views and opinions expressed were current as of March 21, 2016. We encourage you to consult your Financial Advisor regarding your personal investment program.

UBS Asset Management (US) Inc. serves as distributor for 29 US SEC-registered money market funds and is located at 1285 Avenue of the Americas, New York, NY 10019.

For more information on money market funds, contact your Financial Advisor or call UBS Asset Management (US) Inc. at 888-793 8637. He or she can send you a current prospectus, which includes a discussion of investment risks, sales charges, expenses and other matters of interest. Please read it carefully before you invest.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although each money market fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in a money market fund.

Money Market Funds—Not FDIC insured. May lose value. No bank guarantee.

UBS416.6741C 16-0226 4/16
www.ubs.com/am-us

UBS Asset Management (Americas) Inc. is an indirect asset management subsidiary of UBS Group AG.

UBS