Treasury Strategies
A Division of Novantas, Inc.
The Power of Experience®

The Cost of Implementing the 2016 MMF Regulations

In 2014, the Securities and Exchange Commission (SEC) adopted new regulations for Money Market Funds (MMFs) which were implemented in Oct. 2016. The dust has now settled and we now know these regulations decimated both Prime and Tax Exempt, removing $1.2 trillion in capital from the private sector and raising the cost of borrowing for municipalities and businesses across America. HR 2319, the Consumer Financial Choice and Capital Markets Protection Act of 2017, restores some of the important features of MMFs and will allow capital to once again flow efficiently into America's businesses and municipalities.

Concerns have been raised about the cost of implementing the SEC rules, and changing some aspects of them so soon before the $2.7 trillion fund industry has had time to "recover" its investment. The facts suggest that the concerns are overstated.

<u>Implementation Costs for the Industry</u>
Prior to establishing its MMF regulations, the SEC solicited comments regarding the cost of implementation. Many, including Treasury Strategies, estimated that the systems and operational realignment necessary for both the fund companies and investors to comply would range from a one-time investment of several hundred million dollars industry-wide to more that one billion dollars. We also estimated that ongoing operating costs would rise.

These costs did not materialize for several reasons.

- Corporate and institutional investors chose to move into government MMF and exit prime MMFs rather than make systems changes.
- Banks and other fiduciaries chose to exit tax exempt MMFs rather than incur the cost and manage the uncertainty of complying with the regulation's ambiguities.
- Many fund companies simply chose to sell their funds to larger firms to avoid the implementation cost.
- Some fund companies, including many municipal fund sponsors simply closed their funds.
- Large fund companies closed or merged many of their smaller, specialized funds into their larger funds to reduce costs.

In the absence of any industry post-implementation cost studies, we held conversations with several industry players to form a best estimate of the true sunk costs of implementation. Because of the consolidation mentioned above, only a handful of fund companies now hold the lion's share of fund assets. Information from some of the industry's largest fund companies suggests costs of between $5 and $20 million each. In addition, bank custodians and third party record keepers spent similar amounts to comply. On that basis, we estimate that **total one-time implementation costs range from $120 - $200 million over the 2015-16 period.**

Treasury Strategies
A Division of Novantas, Inc.
309 W. Washington
11th Floor
Chicago, Illinois 60606
t +1 312-443-0840
f +1 312-443-0847
www.TreasuryStrategies.com

Who Paid the Implementation Costs?
Most of these estimated $120-200 million in costs were incurred in 2015-16. Because of their structure, funds pass much of their costs and fees on to shareholders. Thus, **these costs have actually been absorbed by the funds' customers and not the fund industry itself.**

Funds tally all their operating expenses and advisory fees and pass them through to their customers via a mechanism called the "expense ratio". Some fund companies waive some of their expenses for competitive marketing reasons, thereby reducing their expense ratio. However, those should be properly viewed as marketing expenses and not implementation expenses.

The Investment Company Institute estimates that actual MMF expense ratios increased from 13 basis points (0.0013%) in 2015 to 18 bps (0.0018%) in 2016. To put that in real dollar terms, based on total industry assets of $2.7 trillion, **the fund companies passed on to their clients total expenses of $3.5 billion in 2015 and $4.8 billion in 2016, easily absorbing the one time $120 - $200 million implementation cost.**

Since investors picked up the tab, why hasn't there been more of an outcry?
Very simply, relative to the size of the funds, these costs are inconsequential. Assuming a high estimate implementation cost of $200 million spread over two years, the net impact is a yield reduction of 0.000037%. This is well below the radar of just about all MMF investors.

Furthermore, the cost to implement HR 2319 going forward is virtually zero since the original technology can be put back into place. In fact, it remained in place for treasury and government money funds which were exempted from the elements of original SEC regulation that HR 2319 seeks to reinstate. All that is required is some modification of the prospectus language and adjustments to the fund websites.

Why is this urgent?
Prime MMF investors moved $1.1 trillion (75% of the total) out of prime funds. These are funds which invest in the working capital of America's businesses, thereby materially shrinking the pool of capital available to business. That reduces availability of capital and ultimately raises borrowing costs which impede growth. Large companies can still easily borrow from their banks. However, since that lending poll is finite, many small business at the margin lose access to credit entirely. For every $1 billion that a large company must now borrow from a bank, that means that 10,000 small businesses will lose access to $100,000 lifelines.

Tax Exempt MMF investors moved $125 billion out of TEMMFs, fully half of the market. TEMMFs invest in the short-term debt of communities, hospitals, universities and infrastructure. These organizations have seen their borrowing costs surge. Between January 2016 and August 2017 (the latest period for which data are available), municipal short term borrowing costs have increased at double the after cost of the Fed rate increase over that same period.

Finally, investors are also penalized. Cranedata reports that as of mid-October 2017 the institutional returns on government MMFs are 20 bps lower than returns on prime MMFs. Since investors moved $1.1 trillion from prime to government MMFs, they have been forced to forego 0.20% in yield. That translates to $2 billion per year in lost income which could have been investmed back into their business or their communities.

<u>Conclusion</u>

The dust has settled. SEC money fund regulations announced in 2014 and implemented in 2016 has caused a in $1.2 loss of investment capital for businesses and municipalities. This unintended capital scarcity is easily remedied by HR2319. Those who argue that the "fund industry" needs more time to absorb its sunk implementation ignore several facts.

- The one time $120-200 million in implementation costs is an insignificant part of the $4.8 billion in annual expenses that the industry passed through to its customers last year.
- The one time $120-200 million in implementation costs is an insignificant part of the $2.0 billion in annual yield which investors are losing each year on their investments in government funds vs. prime funds.

About Treasury Strategies

Treasury Strategies, a division of Novantas, Inc., is the leading treasury consulting firm. Armed with decades of experience, we've developed solutions and delivered insights on leading practices, funding, treasury operations, technology, investment and risk management for hundreds of companies and governmental entities around the globe.

We serve corporate and municipal treasurers, their financial services providers and technology providers for the complete 360° view of treasury.
Novantas is the industry leader in analytic advisory services and technology solutions for retail and commercial banks. We create superior value for our clients through deep and insightful analysis of the information that drives the financial services industry — across pricing, product development, treasury and risk management, distribution, marketing, and sales management.

With more than 200 professionals, Novantas and Treasury Strategies make a formidable team in both bank and treasury markets. Email us at info@treasurystrategies.com