Beyond Money Market Reform:

The Future of Cash Management in Defined Contribution Plans

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Summit recommends plan sponsors remove prime money market funds from their Defined Contribution retirement programs in view of new SEC regulations that place liquidity restrictions on the asset class.

On October 14, 2016, the US Securities and Exchange Commission (SEC) will implement new money market regulations that will profoundly impact cash equivalent investments offered within defined contribution (DC) and defined benefit (DB) plans. At the heart of these regulations is the intent to better safeguard investors' capital in money market funds. Long viewed as a true surrogate for cash, these funds were exposed as vulnerable to systemic risk during the 2008 financial crisis, prompting calls for better regulation. Specifically, on September 16, 2008, a retail money market fund offered by The Reserve, a prestigious New York investment manager, failed to maintain a $1 per share NAV, or "broke the buck." The fund's investments in commercial paper issued by Lehman Brothers quickly became worthless overnight when Lehman filed for bankruptcy. The outcome as investors rushed to withdraw their money was an unprecedented run on the asset class with several other funds coming close to failing. As a result, the US Treasury stepped in and offered insurance to guarantee the value of all money market funds.

IMPACT ON PRIME MONEY MARKET FUNDS

It is not surprising that prime money market funds, which invest in commercial paper, became a focus of the new SEC regulations. Prime funds are commonly employed in both DB and DC plans, and represent over half of the $2.7 trillion money market industry by assets.[1] In an effort to preserve investor capital in this riskier segment of the money market fund industry, the SEC's regulations placed a series of liquidity constraints on prime funds in the event of investor redemptions.[2] As a result, by turning a formerly liquid asset class into one with potential liquidity lockups, the regulations have effectively changed their liquidity profile. This in turn has compelled plan sponsors and Third-Party Administrators (TPA)/recordkeepers to reassess their appropriateness. For DC plans that continue to hold prime money market funds, sponsors should factor in the potential, however remote, for increased participant complaints and the disruption of plan operations.

1. **Increased Participant Complaints –** DC plan participants that rely on regular distributions from their plan accounts may not be able to access their liquid funds during periods when they need them the most (i.e., retirees during periods of market declines). This scenario is likely to generate significant participant discontent and complaints directed at the plan sponsor.
2. **Disruption of Plan Operations –** Under the new regulations, prime money market managers may suspend fund redemptions for up to 10 days and/or impose liquidity fees of up to 4% indefinitely – potentially freezing plan accounts and halting certain aspects of the plan's administration, including:
   - Participant distributions;
   - Distribution of plan forfeitures;
   - Utilization of and/or rebating fund revenue share;
   - Rebalancing of model portfolios;
   - Brokerage windows/self-directed investment vehicles;
   - Fund exchanges and other operational cash sweeps; and
   - Plan loans and loan repayments.

DC plan sponsors that wish to maintain a prime money market fund within their plan should clearly communicate the liquidity risks associated with the product to plan staff, third-party vendors, and participants. More importantly, all plan sponsors as fiduciaries should ask themselves the following question: Is it prudent to introduce additional risk into areas of the plan's administration where risk has historically been minimized and/or presumed to be risk free?

[1]Source: Morningstar.
[2]According to the new regulations, a prime money market fund's board of directors may impose liquidity fees of up to 2% on redemptions, and/or temporarily suspend or gate redemptions for up to 10 days in a 90-day period if the fund's weekly liquid assets drop below 30% of total assets. Furthermore, if the weekly liquid assets drop below 10% of total assets, the board would be required to impose a liquidity fee of 1% on all redemptions unless the board determines that it would not be in the fund's best interest or that a higher (up to 2%) or lower fee is more appropriate.

While the focus of this paper is on DC plans, it should be acknowledged that there are also implications for DB plans. The new regulations separate prime money market funds into two categories: retail funds for DC plans (considered retail investors as they are comprised of natural persons), and institutional funds for DB plans (classified as institutions). In addition to imposing the same liquidity constraints on institutional prime funds, the regulations also require these funds to adopt a floating Net Asset Value (NAV) structure. This calls into question the future role of these products within DB plans as their status as a true cash equivalent has changed (i.e., their former guarantee of a stable $1 NAV no longer applies). Many of the considerations faced by DC plan sponsors therefore also apply to DB plans, if not more so.

The Alternative: Government and Treasury Money Market Funds

Far from being limited to prime money market funds, the new regulations have also improved protections of investor capital in government and Treasury money market funds as well. In fact, by providing a narrower definition of what constitutes a government money market fund and by exempting both government and treasury funds from the liquidity restrictions imposed on prime funds, the SEC has established government/Treasury money market funds as the de facto low risk alternative to prime funds. Under the new regulations, neither government nor Treasury funds are required to impose any redemption gates or fees in the event of dramatic investor redemptions. Moreover, the regulations now require government money market funds to hold over 99.5% of the portfolio's assets in cash, government securities, or repurchase agreements collateralized with government securities. Finally, prime, government, and Treasury money market funds must be clearly labeled as such in the product's name. As a result, the new regulations have compelled the mutual fund industry to more clearly delineate money market funds into two risk buckets: (1) low risk government and Treasury money market funds and (2) higher risk prime funds.

Industry's Response

Summit conducted a survey of some of the largest TPA/recordkeepers in the industry to quantify the industry's response to the new regulations (see table below). With the exceptions of Fidelity and Vanguard, the majority of TPA/recordkeepers have decided not to continue to support prime money market funds on their platforms for DC plans. The primary reason given by respondents was that they did not wish to incur the additional administrative burden and subsequent cost of supporting these products, given their potential for liquidity fees and suspensions.

While the majority of TPA/recordkeepers have elected to no longer support prime funds, there are certain differences concerning how each firm will handle the funds moving forward, including:

- **TIAA-CREF/Voya/T. Rowe Price/ Transamerica/VALIC –** these firms will all require DC plan sponsors to offer a government money market fund within their plans.
- **Fidelity –** Even though Fidelity continues to support prime money market funds on its platform, it is requesting clients that retain a prime money market mutual fund add a contingency government money market fund to the plan(s) as well.
- **Vanguard –** This provider has staunchly defended the use of prime money market funds in DC plans and will continue to support them for their recordkept plans. The firm's position is that their prime funds are managed conservatively and have historically maintained high liquidity rates.
- **Wells Fargo –** The provider is planning to automatically switch their recordkept DC plans' investments in prime funds to government money market funds. Plan sponsors do have the option to opt out of the automatic switch and retain their prime fund. In this case, however, the plan must offer both a prime and a government money market fund.

Summit Survey of TPA/Recordkeepers

TPA/Recordkeeper	Total DC Recordkept Assets ($MM)*	Support Prime Funds on Platform?	Prime Permitted in Plan Operational Cash Accounts?**	Prime Permitted in Brokerage Window/Self Directed Accounts?
Fidelity	$1,445,635	Yes	Yes, but discouraged.	Yes, but discouraged.
TIAA-CREF	$429,808	No	No	No
Empower Retirement	$416,313	No	No	No
Aon Hewitt	$394,058	No	TBA	TBA
Vanguard	$389,402	Yes	Yes	Yes
Voya Financial	$352,173	No	No	No
Wells Fargo	$217,500	No	No	TBA
Xerox HR Solutions	$194,398	TBA	TBA	TBA
T. Rowe Price	$146,439	No	No	No
Transamerica	$125,323	No	No	No
MassMutual	$120,810	No	TBA	TBA
VALIC	$84,706	No	No	TBA

* Source: Plan Sponsor 2015 Recordkeeping Survey.
** Including cash sweeps, forfeiture accounts, revenue sharing accounts, participant distributions, securities lending accounts, loan repayment accounts, etc.
TBA = To Be Announced.

There is evidence to suggest that the decision by some of the largest TPA/recordkeepers to discontinue supporting/promoting prime money market funds within DC plans is already having an impact on the money market industry. As of March 31, 2016, government and Treasury money market funds have experienced net fund inflows of $42.5 billion or 5% YTD, while prime money market funds have suffered net outflows of $37.9 billion, or -2%.[3] Equally important is the response among DC plans to-date. In a survey conducted by Fidelity in 2015 of 600 defined contribution plans, nearly two-thirds of those surveyed said that they would change their investment menu prior to October 2016 to offer only government money market funds.

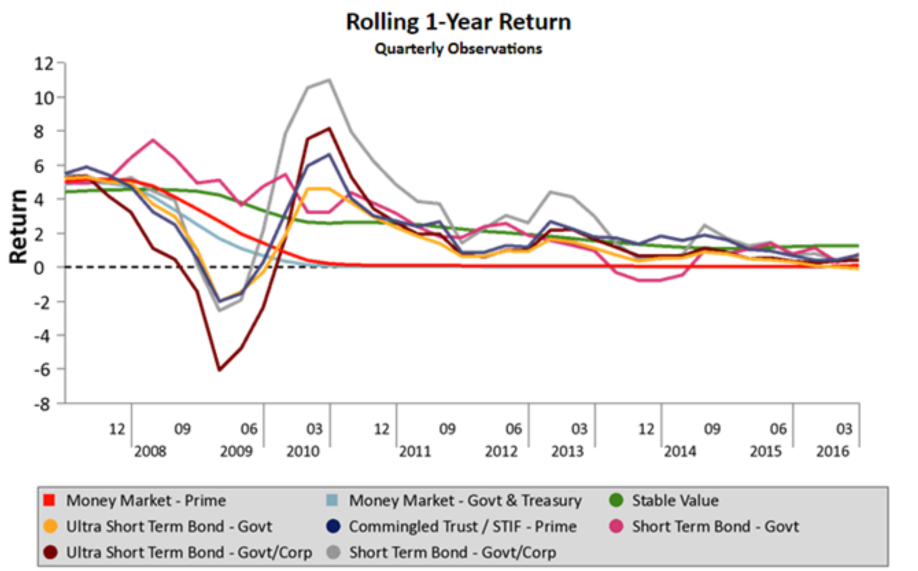
The Future of Cash Management in Defined Contribution Plans

Given industry trends and the potential risks that prime money market funds now pose to plans and their participants, Summit recommends that all sponsors remove prime money market funds from their DC plan's investment menu. Inevitably, a decision should follow concerning potential replacements for a prime fund in the plan. In light of this, it is prudent for all plan sponsors to re-examine their plans' cash management strategy at this time. Questions sponsors should address include:

1. **Is offering a government money market fund alone sufficient to fulfill participants' need for capital preservation, liquidity, and yield in a rising interest rate environment?**
2. **Should the plan seek an "all-in-one" strategy as a replacement for the prime money market fund (i.e., one that offers capital preservation, liquidity, and higher yield such as a stable value fund)?**
3. **Is a cash segmentation strategy warranted where different short-term instruments are used for strategic income versus liquidity and capital preservation (e.g., a government money market fund for capital preservation and liquidity, and a short-term bond fund for income)?**
4. **Should the plan use government money market funds exclusively for plan-level operational accounts (forfeitures, revenue share, etc.) and designate other short-term investments for participants?**
5. **What is the strategy for communicating these changes to participants?**

To assist plan sponsors with answering these questions, the chart to the right shows the historical risk and reward spectrum of popular short-term, income-focused investments. In the present low interest rate environment, the yield spread between these products is negligible as indicated by the convergence of lines at the end of the chart (as of 3/31/2016).

However, during 2008-2010, these products produced a wide dispersion of returns during periods of market volatility and/or changes in interest rate regimes. Given that yield spreads should increase again in the future, plan sponsors should factor in each product's potential market risk to participants. In all cases, the risks and objectives of the products selected should be clearly communicated to participants.



Source: Morningstar. All returns are net of fees (only Institutional, Retirement and Investor mutual fund share classes included).

[3]Source: Morningstar

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