clearwater ADVISORS

MARKET Commentary

New Challenges

The global financial environment continues to evolve since the financial crisis, posing new challenges to investors and corporate treasury staff. Recent money market regulatory changes and the ongoing evolution of global banking oversight serve as stark reminders that the investment landscape can be materially altered. Consequently, market participants should reassess their current approach mindful of the new risks present. Inertia is not a viable option.

The excesses leading up to the Great Recession fueled record bank profits and lofty ratings. The revelry ended abruptly with the failure of Lehman Brothers in September 2008. Now, some six years later, banks are coping with onerous regulations, legal reparations, and stricter oversight as authorities attempt to stave off future bailouts. “Too big to fail” and “moral hazard” should become outdated concepts if all goes according to plan. The money fund industry faced similar challenges following its near collapse. The Securities Exchange Committee (SEC) pressed forward with additional reform that significantly alters the risk profile of prime institutional funds. Stable value and same day liquidity will no longer be synonymous with prime funds. In this commentary, we’ll examine the current regulatory environment for money funds while providing an update on the state of banks.

Money Market Reform

The SEC approved rules aimed at reducing the susceptibility of institutional money funds to runs during periods of financial stress and increasing the transparency of risk in money market funds. Today’s vote concludes a four-year battle by regulators to toughen rules after investor runs at the height of the financial crisis forced the Treasury and Federal Reserve to backstop the industry. The rule changes include:

- *Floating Net Asset Value (NAV)* – Prime institutional, including tax-exempt, money market funds will be required to transact at a floating, market-based net asset value rather than maintain a $1.00 stable share price. Government and retail funds will continue to utilize a stable NAV.
- *Redemption Limits* – All non-government money market funds will be able to use liquidity fees (up to a 2% fee on redemptions) and redemption gates (a temporary suspension of redemptions) when a fund’s liquidity falls below a certain level (15% of its total assets). Government money market funds could voluntarily utilize these limits, if previously disclosed to investors.
- Additional disclosure requirements for money market funds such as daily holdings reports, historic instances of sponsor support, and new material events.
- Amendments to enhance fund diversification, stress testing and reporting requirements to improve the risk profile of money funds.

Summer 2014

US Treasuries
As of 30-Jun

Benchmark	Yield
3 Month	0.02%
6 Month	0.06%
1 Year	0.10%
2 Year	0.46%
5 Year	1.63%
10 Year	2.53%
30 Year	3.36%

Bank of America/Merrill Lynch Indexes
31-May to 30-Jun

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.04%
1-3 Yr Municipals	0.05%
1-3 Yr Agencies	-0.09%
0-3 Month UST	0.00%
S&P 500	2.06%

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Source: British Bankers’ Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, S&P and Wall Street Journal

The compliance date for the floating NAV and fees and gates amendments will be two years. The compliance date for most of the other amendments and disclosure requirements will be 18 months. In conjunction with the SEC vote, the Internal Revenue Service released new regulations allowing for streamlined tax treatment for investors in floating NAV money funds.

The new rules remove major certitudes of institutional prime money funds – stable value and daily liquidity. Regulators have offered investors a window to assess these risks over the next couple of years. **However, the vote should serve as a catalyst to assess your liquidity needs and determine the appropriate investment options for your firm.**

Stand By Me

Regulatory authorities have struggled to create a framework for the resolution of troubled banks that removes the implied sovereign support provided during the financial crisis. Prior to 2008, government support played a significant role in the ratings agency methodology, inflating ratings. Now as regulatory changes codify less support, the ratings agencies are grappling with how to incorporate less sovereign support in ratings going forward. Dodd-Frank attempts to end "too big to fail" by enabling the government to wind down a failing financial institution that presents systemic risk, rather than support it. This procedure is carried out by the Orderly Liquidation Authority (OLA) via the Treasury Secretary with the goal of maintaining financial stability, maximizing creditor recoveries and not using public funds to bail out institutions.

Domestically, Moody's has removed sovereign support from bank holding company ratings (See Figure 1). However, bank operating company ratings still enjoy a sovereign ratings boost and may continue to do so as the ratings agencies determine the level of extraordinary government support that will be provided going forward.

Figure 1: Select U.S. *Bank Holding Company* & Bank Ratings

Bank	Moody's LT	Moody's Sovereign Support	Moody's ST	Moody's Outlook	S&P LT	S&P Sovereign Support	S&P ST	S&P Outlook	Country	Country Rating S&P	Country Rating Moody's
JPMORGAN CHASE & CO	A3	0	P-2	STABLE	A	1	A-1	NEG	US	AA+	Aaa
JPMORGAN CHASE BANK NA	Aa3	3	P-1	STABLE	A+	1	A-1	STABLE	US	AA+	Aaa
BANK OF AMERICA CORP	Baa2	0	P-2	STABLE	A-	2	A-2	NEG	US	AA+	Aaa
BANK OF AMERICA NA	A2	3	P-1	STABLE	A	2	A-1	NEG	US	AA+	Aaa
WELLS FARGO & CO	A2	0	P-1	STABLE	A+	1	A-1	NEG	US	AA+	Aaa
WELLS FARGO BANK NA	Aa3	2	P-1	STABLE	AA-	1	A-1+	STABLE	US	AA+	Aaa
CITIGROUP INC	Baa2	0	P-2	STABLE	A-	2	A-2	NEG	US	AA+	Aaa
CITIBANK NA	A2	3	P-1	STABLE	A	2	A-1	STABLE	US	AA+	Aaa
MORGAN STANLEY	Baa2	0	P-2	STABLE	A-	2	A-2	NEG	US	AA+	Aaa
GOLDMAN SACHS GROUP INC	Baa1	0	P-2	STABLE	A-	2	A-2	NEG	US	AA+	Aaa

Source: S&P, Moody's & Clearwater

S&P is gradually working on restructuring their ratings to reflect less sovereign support. Bank holding company ratings, which are structurally subordinate to the bank operating company, will reflect little to no support due to the likelihood that holding company bondholders will bear losses in the event of a systematically important bank liquidation. The recent bailouts fell below holding company debt in the capital structure, but in the future should a failing institution's capital be so weak, losses could impact holding company debt.

Overseas, bank balance sheet repair and the regulatory environment have evolved more slowly. The European Union and other developed economies are attempting to remove government support as well. They are focusing on a bail-in methodology that would require bondholders and uninsured depositors to bear the cost of a failing bank. Japan and Canada have discussed potential rule changes while the European Union is moving forward with a central banking authority as well as a uniform banking resolution based on a bail-in system targeted to be in place by January 2016. European bank ratings will trend lower over the remainder of the year as the ratings agencies incorporate a reduced level of sovereign support (see Figure 2). Canadian and Japanese banks have a longer reprieve as their regulators are just beginning to outline their plans. Australia has not moved to withdraw sovereign support at this time.

Figure 2: Select Foreign Bank Ratings

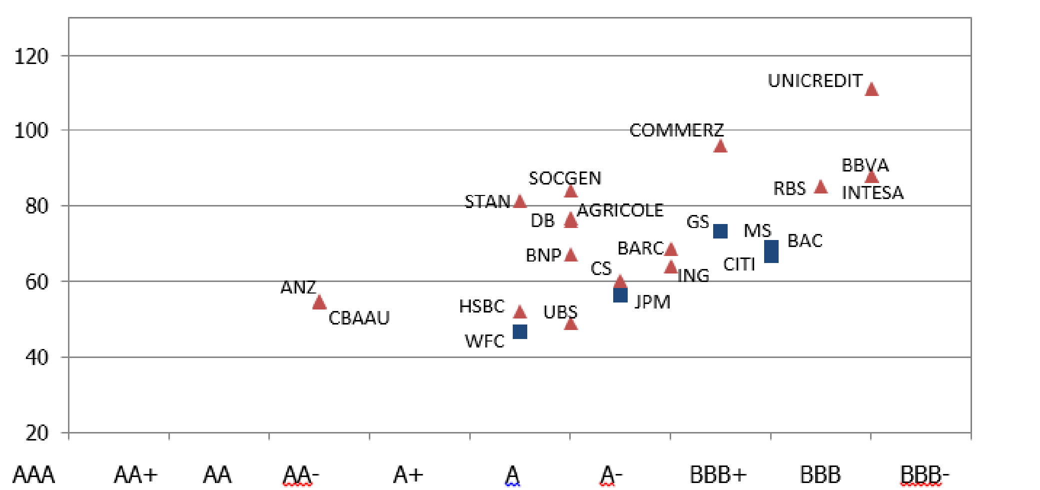
Bank	Moody's LT	Moody's Sovereign Support	Moody's ST	Moody's Outlook	S&P LT	S&P Sovereign Support	S&P ST	S&P Outlook	Country	Country Rating S&P	Country Rating Moody's
BANK OF MONTREAL	Aa3	2	P-1	NEG	A+	2	A-1	STABLE	CA	AAA	Aaa
WESTPAC BANKING CORP	Aa2	2	P-1	STABLE	AA-	2	A-1+	STABLE	AU	AAA	Aaa
BNP PARIBAS	A1	3	P-1	NEG	A+	1	A-1	NEG	FR	AA	Aa1
DEUTSCHE BANK AG-REGISTERED	A2 *-	3	P-1 *-	NR	A	2	A-1	NEG	GE	AAA	Aaa
HSBC BANK PLC	Aa3	3	P-1	NEG	AA-		A-1+	NEG	GB	AAA	Aa1
BANCO BILBAO VIZCAYA ARGENTA	Baa2	0	P-2	POS	BBB	0	A-2	STABLE	SP	BBB	Baa2
BANK OF TOKYO-MITSUBISHI UFJ	Aa3	3	P-1	STABLE	A+		A-1	STABLE	JN	AA+	Aa3

Source: S&P, Moody's & Clearwater

The Global View

The ratings transition has been gradual enough that markets have not punished banks via higher spreads for lower ratings. Even though earnings power has been diminished due to regulatory limits, balance sheets look solid away from Europe which is slowly improving. It is apparent that investors tend to view U.S. financial institutions (see Figure 3) as less of a credit risk than their global counterparts rewarding domestic banks with lower borrowing costs. Currently, comparatively weak balance sheets and regulatory uncertainties are leading to higher costs for Eurozone banks in the debt markets.

Figure 3: CDS vs. Credit Ratings of Global Financial (Red) and U.S. Financial (Blue)



Source: Bloomberg

Given the disparate national interests in the EU, authorities lurched from crisis to crisis with ad hoc decision making. This inconsistent approach delayed its banking sector recovery and consequently hampered the economy. However, Eurozone banks are slowly making progress. We are now closer to a healthier banking sector with reasonably strong balance sheets than in years past.

Looking Forward

Money market reform has finally come to pass. The absence of stable value and the addition of liquidity restraints significantly alter the investment profile of prime money funds. Simply moving to a government fund restores these features, but sacrifices yield. Further utilizing bank deposits increases concentrated credit risk without commensurate compensation. It is time to evaluate viable alternatives and determine the appropriate mix of investments for your risk profile.

The global banking sector continues to adapt to the evolving landscape. U.S. banks appear better positioned in the current environment alongside financial institutions in Australia, Canada and Japan. Australia and Canada have country specific issues that bear monitoring closely, however. In the Eurozone, we like select banks and are waiting to see stress-test results before considering broader participation. In all cases, we are cautious buying bonds further down the capital structure. Somewhat troubling, there has been little negative price action (wider credit spreads) below senior debt in U.S. banks even as regulations push more risk to this class of debt holders. As always, there are idiosyncratic risks and valuation considerations that factor into portfolio positioning and appropriate cash management exposure.

Please contact the desk with questions or to discuss your bank exposure and how to best navigate changes to the money fund landscape.

Form ADV Part II

Clearwater Advisor's annual Form ADV Part II disclosure is available to clients upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call Brittany Pfister at 208-489-7550.