Government Investment Officers Association

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September 2011 Newsletter

In This Issue:

A Message From Our President

Any change, even a change for the better, is always accompanied by drawbacks and discomforts."
-Arnold Bennett

Changes…we've seen a lot of them in the last few years. We've changed from the so called normal to the "new normal". The new normal includes painfully low interest rates, a depressed housing market, an unstable global economy, high unemployment, and a lack of job security for those employed.

Bernanke's "no change in interest rates" has probably been the most painful for those managing short-term money. With fed funds pegged at a historic low of 0 to .25% since December 2008, many of us would welcome a change in interest rates. This lack of change has many municipalities searching for yield in order to meet interest income forecasts. With interest rates at historic lows and with Bernanke's promise to keep them there until mid-2013, what do we as government investment officers do to increase yield without taking on undue risk? In this newsletter Margaret Kerins with RBS Securities discusses the potential value in adding callable securities to a portfolio.

Changes in liquidity requirements for money market funds regulated by the SEC's Rule 2a-7 have also had a significant impact on interest rates. Effective May 5, 2010, Rule 2a-7 was amended requiring money market funds to hold 10% of total assets in daily liquid assets (taxable funds only) and 30% of total assets in weekly liquid assets.

Continued on Page 2.....

A Message From Our President *(Cont.)*

Meanwhile a new liquidity framework for banks proposed by the Basel Committee on Banking Supervision created some tension with these new liquidity requirements for money market funds. Banks are being pushed toward funding themselves with longer dated maturities while Rule 2a-7 is pushing money market funds towards shorter maturities. This supply and demand imbalance has also pushed rates lower in the front end of the curve.

Peter Rizzo with Standard & Poor's (S&P) spoke at last year's conference on potential changes in principal stability fund ratings criteria and effective November 1, 2011 the changes discussed will be the new standard. Some of the main criteria changes include the establishment of explicit issuer or counterparty credit ratings, the adoption of weighted average maturity (WAM) for all principal stability fund rating (PSFR) categories, the establishment of a maximum final maturity of 397 days for all investments other than certain AA- or higher-rated sovereign floating rate securities, and the introduction of monthly stress testing guidelines. For a full copy of the new criteria, please use the following link: http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245319320838

The Dodd-Frank Deposit Insurance Provision effective from December 31, 2010 through December 31, 2012 also brought about changes in banking relationships. Effective December 31, 2010, all funds in non-interest bearing transaction accounts held at FDIC-insured depository institutions will be fully insured. In the state of Georgia, we have seen numerous banks offer earnings credit rate (ECR) accounts. This type of account is simply a daily calculation of interest that reduces bank service charges.

Finally a change we thought might never happen did. On August 5, 2011, S&P downgraded the U.S. credit rating for the first time to one notch below AAA. This rating change had a ripple effect as S&P also lowered the ratings of Fannie Mae, Freddie Mac, Federal Home Loan Bank and the Farm Credit system by one notch to AA+. S&P's downgrade of U.S. Treasuries and Agencies forced many investors to reexamine their investment guidelines. What high quality securities are available with a reasonable spread to treasuries and still rated AAA? Inside this newsletter is an article on supranational issuers such as World Bank that meet this standard of high quality while providing additional income over treasuries.

As Johann Wolfgang von Goethe said years ago, "Life belongs to the living, and he who lives must be prepared for changes." We hope you will join us March 21-23, 2012 in Las Vegas for our annual conference. We will help you navigate these changes and more, and provide you with the knowledge and tools necessary to succeed in maintaining a solid portfolio that is properly positioned for the current low rates as well as the change in rates that could greatly impact your portfolio and performance.

Hope to see you in Las Vegas in March for some Market Madness!

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The 8th Annual GIOA Conference will be held March 21-23, 2012 at the Monte Carlo Resort & Casino in Las Vegas.

Online Registration

Visit our website at **www.GIOA.us** to register for the conference and get the most up to date information about our welcome reception on Wednesday evening and the "March Madness" party on Thursday evening.

Hotel Reservations

Call 800.311.8999 today to make your reservation. Mention group code XGIOA03. The room rate is $65, plus a mandatory $15 resort fee, and is good until February 20, 2012.

Visit **www.montecarlo.com** to see all they have to offer.

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GIOA
Government Investment Officers Association

2012 GIOA Conference Preliminary Schedule

Wednesday, March 21

9:00 am – 12:00 pm	Pre-Conference Workshops/Roundtables (Government Attendees Only)
12:00 pm – 1:00 pm	Lunch Provided
1:00 pm – 4:00 pm	Pre-Conference Workshops/Roundtables
5:00 pm – 7:30 pm	Welcome Reception (All Attendees Invited)

Thursday, March 22

7:00 am – 8:00 am	Registration
7:15 am – 8:15 am	Full Breakfast Provided
8:00 am – 12:00 pm	General Session/Speakers
12:15 pm – 1:30 pm	Lunch Provided
1:30 pm – 4:30 pm	General Session/Speakers
5:30 pm – 8:00 pm	March Madness Get Together (All Attendees Invited)

Friday, March 23

7:15 am – 8:15 am	Registration and Full Breakfast
8:00 am – 11:30 am	General Session/Speakers
11:30 am	Conference Concludes

How Long Will Callables Offer Value?

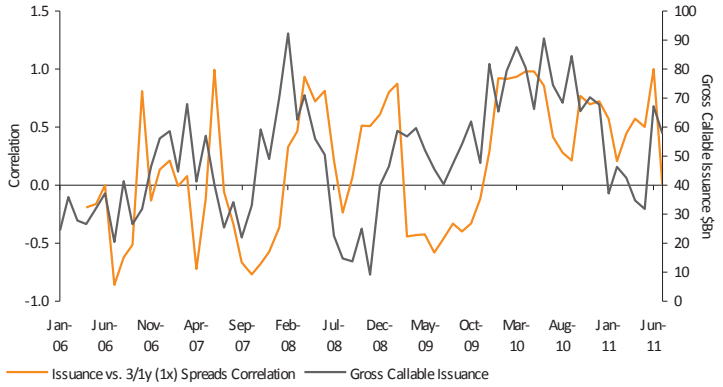
We recommend taking advantage of current valuations in callables, which we do not expect to persist much beyond the third quarter. The combination of cheap bullet valuations versus swaps and heavy gross callable issuance has pressured callable funding levels resulting in better coupons than otherwise would be available. Once the redemption cycle passes, callable valuations should richen due to low volatility and declining issuance.

When gross callable issuance is heavy, it tends to dominate the other factors that impact callable spreads including volatility. Currently, heavy callable redemptions are driving heavy issuance, cheapening callable agencies versus bullets despite the fact that volatility is at historic lows for many structures with the Fed on hold for at least 2 years. The expectation of very low rate volatility is also reflected in the ratio of implied to realized volatility, which is now at historic lows. Once the issuance cycle passes, the lack of volatility should result in tighter callable spreads versus bullets.

Current Factors Impacting Callable Spreads

1 Callable redemptions have been heavy at $400 bn YTD

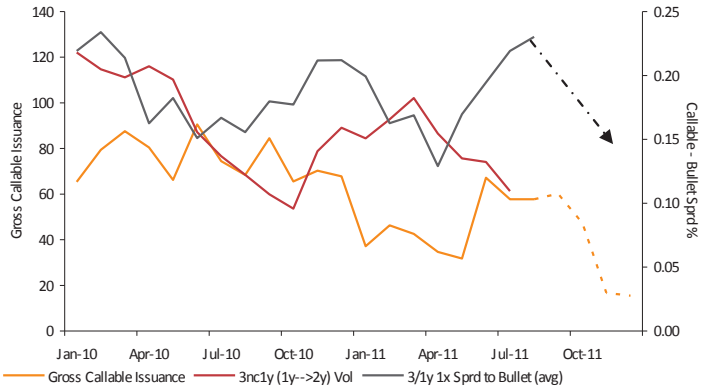
Figure 1: Gross Issuance vs. Correlation Gross Issuance to Callable Spreads



Source: RBS, Bloomberg

turning over 80% of the callable market. In addition, we estimate that about 45% of the callable agency market (about $220bn) is in the money to be called through year end. This translates into high replacement needs, and callables remain the optimal funding tool as the embedded optionality helps to offset the prepayment risk in the retained portfolios.

Figure 2: 3/1y 1x Callable Sprd/Bullets vs. Issuance & Vol Monthly



Source: RBS, Bloomberg

2 The second reason that the GSEs have cheapened callable funding levels is that bullets are cheap versus swaps. For example, 3yr callables are being funded at L-3 bp which is even to where 3yr bullets would be issued after accounting for a 2 bp new issue concession. At even valuations, callables are the preferred

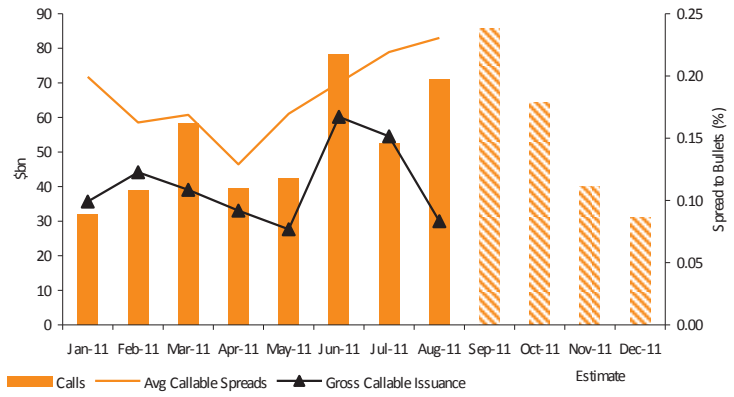
How Long Will Callables Offer Value? (cont.)

funding vehicle even though the GSE would prefer to issue callables rich to bullets.

3 Another reason funding is being held cheap is that investor demand for callables would likely decrease if spreads were not wide enough to entice them into structured products. For example, many European calls with 1 year of lockout protection in 3-5yr maturities pick up about 10-20 bp versus similar maturity bullets while Bermudans pick up 20-30 bp. Investor demand would likely fall off if the picks were 5-10bp richer.

Of course, one of the drivers of callable spreads is how far in or out of the money the structures are with spreads narrowing to the final maturity date when they are out of the money and narrowing to the call date when they are in the money. Currently, many of the new issues are out of the money and look like bullet alternatives

Figure 3: 2011 Callable Redemptions/Issuance vs. Avg Monthly 3/1 1x Sprd to Bullets

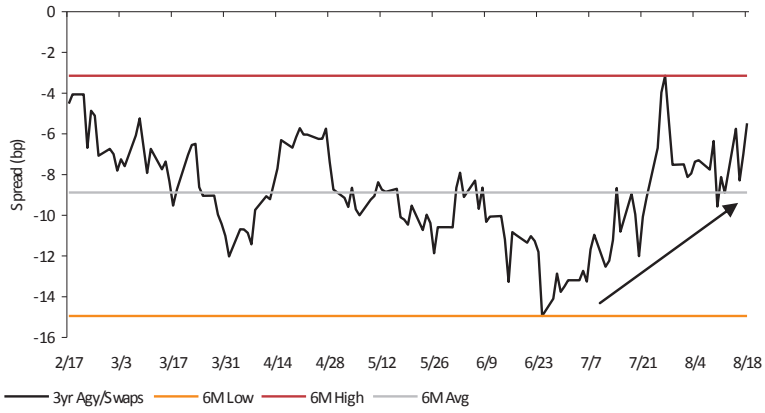


Source: RBS

versus the forwards. The investor play is for rates and vol to stay low and have the bonds roll down the curve and into call.

4 Finally, rates are so low that the absolute yield levels are attractive versus the mortgage-related products the GSEs hold

Figure 4: 3yr Agency Spreads vs. Swaps



Source: RBS

on their books. For example, the average rate earned by Fannie Mae's mortgage-related securities was 4.84% for the 6 months ended June 30, 2011 and the net interest income was 0.62% versus 0.43% over the same period 2010.

How Long Will Callables Offer Value? (cont.)

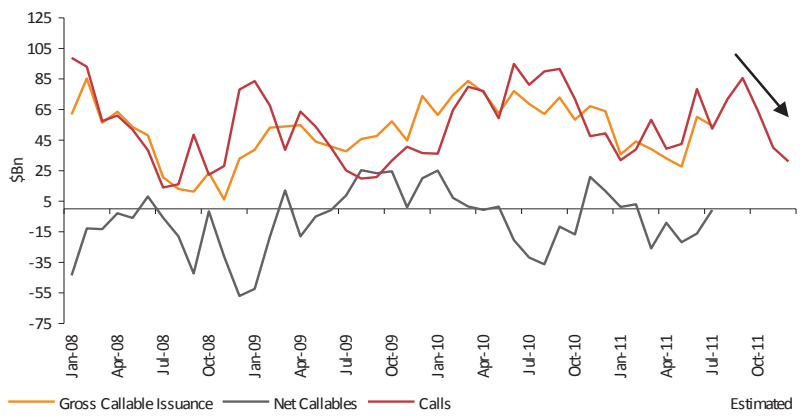
How long will this persist?

- Callable funding should remain cheap as long as bullets are cheap versus swaps and callable replacement needs remain heavy.
- Bullets should richen into any widening in swaps spreads as Europe heats up again in coming months. Another positive factor for bullet spreads is that large deal issuance is taking a break until September 7th when FHLB is set to announce. FHLB funding needs have been light with only 3 globals totaling $9 bn issued YTD, so there is a decent chance they pass. If so, this would push issuance out to mid-September when Freddie Mac and Fannie Mae are on the calendar. A dry spell in issuance typically results in lower dealer inventory and tighter spreads, all else equal.
- We also expect demand to remain strong as investors add structure risk to enhance yield. In addition, we expect the short end of the callable market to benefit from any reduction in money market exposure to European CP and CDs.
- Typically, in a heavy callable redemption wave, the GSEs fund the surge in redemptions with discount notes that get termed into callables over several months. Therefore, net callable issuance is initially negative and then swings into positive territory as callable issuance catches up with redemptions. In this recent wave, net callable issuance has not been as negative in the past so the catch up time frame should be shorter as seen below.

In addition, we think that the GSEs will avoid heading into year-end with heavy issuance needs due to funding risk concerns. Furthermore, the overall trend for callable issuance has been negative with the size of the market shrinking by 14% YTD through July. Also, the GSEs reliance on callable funding has decreased as callables represent only 20% of total outstandings down from a third prior to 2008 when floating rate issuance increased.

Therefore, gross callable issuance is likely to remain heavy for the next four to six weeks as the heaviest call month is September and most of these redemptions will occur by mid-Sept due to the call notice of 10-

Figure 5: Callable Issuance versus Redemptions



Source: RBS

How Long Will Callables Offer Value? (cont.)

day from FNMA and 5-days from FHLMC and FHLB.

Once these replacement needs have been funded, the GSEs are likely to richen valuations into year end. Then, volatility and supply technicals should dominate agency spreads over the long run. However, the agency market is not without near-term risks as discussed below.

Risk to Callable Spreads

- Swap spreads narrow and agency bullets underperform pressuring callable spreads.
- European bank funding crisis puts pressure on Libor, resulting in wider front end swap spreads and pops volatility out. The mitigating factors are that the banks can have access to liquidity through the European Central Bank.
- Issuance needs out of Europe result in USD issuance at wider spreads, pressuring all spread products. Our strategy team in London continues to expect the European Financial Stability Fund (EFSF) to be increased in size from EUR 256 bn to EUR 440bn. The increase must go through parliamentary ratifications which are expected to be completed by the end of September or early October at the earliest.

They expect about 25% of the issuance to be in USD or $92 bn at current exchange rates. This is only 17% of the USD issuance through the government guaranteed bank debt programs ($297 bn FDIC and $240bn non-US government guaranteed programs). In addition, the role of the ECB is likely to expand further in response to the crisis, but the pain threshold for action is extremely high.

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Supranational Issuers – A High Grade Investment Opportunity for US Investors

George Richardson, Head of Capital Markets, The World Bank
Heike Reichelt, Head of Investor Relations and New Products, The World Bank
Urvi Mehta, Financial Analyst, Investor Relations, The World Bank

Introduction

The landscape of high grade investment alternatives has changed drastically for investors over the last few years. The total volume of non-structured products rated triple-A that provide investors with a spread over US Treasuries has been shrinking dramatically over the last few years. Investors need alternative investment options that allow them to protect the credit quality and financial value of their portfolios, but still add value to their income generation or portfolio performance goals.

Recently, the "AAA supranational" sector is getting increased attention from portfolio managers and government investment officers in the US with the fiduciary responsibility to protect the high credit quality of their portfolios, while offering their constituents a stable return or their budgets more income than possible from the US Treasury market. Supranationals are leading issuers of safe haven instruments in the international capital markets, and are important for central bank reserve portfolios around the world, because of their high quality credit, strong performance in the capital markets, and suitability for conservative investment strategies with capital preservation and return objectives. Here in the US, their following by US money managers is growing quickly as alternatives to US GSE's are being sought out. This is particularly the case now after the Standard & Poor's downgrade to AA+ of US Treasuries bonds and GSE's.

The World Bank (officially known as the International Bank for Reconstruction and Development) is the oldest and largest institution in this class of issuers that has recently focused on helping US investors become more familiar with the World Bank and its peer group, including by issuing bonds specifically catering to demand from investment offices here in the US.

What are Supranationals?

A general definition of a supranational is: "international institutions that provide development financing, advisory services and/or other financial services to their member countries to achieve overall goal of improving living standards through sustainable economic growth." They are also sometimes referred to as Multilateral Development Banks (MDBs).

In other words, a supranational is an organization owned by many different countries – like 187 countries for the World Bank– that operates under conservative policies and whose main purpose it is to work with its member countries in different areas, to help them reach their development goals in an environmentally and socially sustainable way. Supranationals fund by borrowing in the international capital markets.

Typical Features:

- Sovereign class triple-A rating
- Sovereign shareholders
- Conservative financial policies, strong financials and capital base
- High quality loan portfolio ("preferred creditor status")
- 0% risk weighted in Basle II and Basle III
- Issuers of variety of products (plain vanilla, callable), in different currencies and sizes
- Offer only one class of issues - senior, unsecured debt.
- Benchmark bonds are included in indices (in the government-related sectors of indices).

Supranationals

(Cont.)

Supranationals share many characteristics, but each has a different regional focus determined by who their shareholders are. Their funding activities also vary because their annual funding program sizes vary significantly and because they have different advantages in various markets, depending on the currency they issue in, and what regulatory regime they operate under in the respective markets. For example, supranationals based in the US with mostly USD-based lending, will rely more on funding in USD. Other issuers focused on lending in Europe and promoting European integration, will also borrow in USD, but issue larger amounts denominated in Euros. Also, entities with the US as a major shareholder may benefit from exemptions that are similar to those for Fannie and Freddie, and share other features specific to bonds issued by the US agencies and US Treasury bonds, like settling USD benchmark bonds through Fedwire. Other supranationals who do not have the US as a major shareholder may still issue bonds in the US market, but they may clear these bonds through DTC rather than Fedwire and they would issue them under fully SEC registered documentation.

Supranationals are part of the "Sovereign Supranational and Agency" sector (SSAs) that bankers often refer to. This group of borrowers includes sovereign issuers offering bonds in currencies not their own, issuers with explicit government-guarantees (like KfW in Germany, or EFSF, the new European Financial Stability Facility), and others with a special government-supported mandate (like BNG from the Netherlands or SEK from Sweden). This

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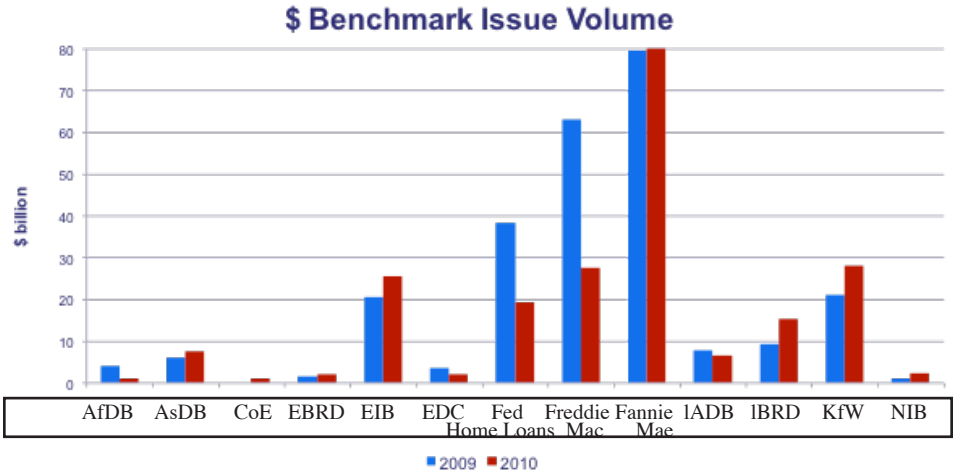
borrower class is often discussed together by market professionals, but the credit for each issuer is different and



should be carefully evaluated.

Taking only the top three issuers of US$ benchmarks by volume in the SSA class (i.e. the World Bank (IBRD), the European Investment Bank and KfW), the volume issued in the past few years is comparable to that of US agencies. And although supranationals cannot replace US agencies in terms of volume, they are an asset class that satisfies many requirements of investors like US state, county and municipal treasuries.

Case Study: The World Bank

The World Bank is an international organization owned by 187 countries and operates like a development cooperative. Set up in 1944 at the Breton Woods Conference in the US, the World Bank is the oldest supranational, and the largest development bank. It works with its member countries to promote equitable and sustainable economic growth. The World Bank Group consists of different organizations that all work in different ways towards this goal. The official name for "World Bank" in the capital markets is IBRD, which stands for "International Bank for Reconstruction and Development". IBRD provides development funding and consulting services directly to governments of "middle-income countries" like Mexico and Brazil, in areas such as education, health, environment, transportation, energy and infrastructure. A separate entity – the aid agency known as International Development Association or IDA – provides funding and services for the poorest countries (IDA is funded through direct contributions from its owners; IDA does not issue bonds) .

To fund its activities, the World Bank raises about $25 billion - $35 billion a year in the capital markets through hundreds of bond transactions offered to investors around the world in different currencies, maturities and structures. The World Bank is rated triple-A and has been issuing bonds in the capital markets for more than 50 years. The US is the World Bank's largest shareholder, with about 17%. The World Bank's high credit rating, shareholder support, strong balance sheet and conservative financial policies, make World Bank bonds an attractive investment for many official sector investors, like central banks, looking for high quality assets.

A list of World Bank bonds and details on World Bank Discount Notes can be found on Bloomberg under (IBRD <Go> or IBRD <GOVT> <Go>). More information for investors on World Bank bonds and a list of recent bonds showing financial distributors of our bonds is available at: http://treasury.worldbank.org/capitalmarkets.

Conclusion

The universe of liquid triple-A bond issuers available to US investors has reduced dramatically and the issuance by GSE's is shrinking. Although supranationals cannot fill the gap created, seen as an asset class, supranationals provide opportunities for conservative US investors to protect the credit quality of their portfolio while meeting performance targets and generating a spread over US Treasuries. The World Bank capital markets teams have been providing investors with information on the fundamentals of the supranational credit, so investors can

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consider this high quality asset class for their portfolios. For more information, please contact the authors at debtsecurities@worldbank.org.

Overview of Sovereign owned Supranationals

Supranationals with international shareholders and financing activities

•**International Bank for Reconstruction and Development (IBRD)** **, known as "The World Bank", established in 1944. The World Bank's headquarters are in Washington, DC. It works with member countries to promote equitable and sustainable economic growth, by providing financing and risk management solutions directly to sovereign governments - globally. More information is provided below.

•**International Finance Corporation (IFC)** **, part of the World Bank Group, created in 1956. Its headquarters are in Washington, DC. It provides investments and advisory services to build the private sector in developing countries.

Supranationals with regionally-focused borrowers and /or shareholders

•**African Development Bank (AfDB)** **, founded in 1964; its headquarters are in Abidjan, Ivory Coast, but it currently operates from Tunis, Tunisia. Its mission is to help reduce poverty, improve living conditions for Africans and mobilize resources for the continent's economic and social development.

•**Asian Development Bank (ADB)** **, established in 1966; its headquarters are in Manila, Philippines. Its mission is to help its developing member countries reduce poverty and improve living conditions and quality of life in Asia and the Pacific region.

•**Council of Europe Development Bank (CEB)**, founded in 1956; it is based in Paris, France and contributes to the implementation of socially oriented investment projects throughout Europe such as strengthening social integration, managing the environment and supporting public infrastructure with a social vocation.

•**European Bank for Reconstruction and Development (EBRD)** **, established in 1991; its headquarters are in London, UK. It finances investment in its member countries across Central and Eastern Europe and Central Asia to promote growth of open and democratic market economies.

•**European Investment Bank (EIB)**, established in 1957. Its headquarters are in Luxembourg. It is the European Union's long-term lending institution and finances projects in its member countries and around the world that aim to promote European economic development and integration.

•**Inter-American Development Bank (IADB)** **, established in 1959. Its headquarters are in Washington, DC. It supports efforts by Latin America and the Caribbean countries to reduce poverty and inequality.

•**Nordic Investment Bank (NIB)**, founded in 1976; its headquarters are in Helsinki, Finland. It finances projects in its member countries of the Nordic Region, both in its member countries and around the world.

** AAA-rated Supranationals that are active in the markets of which the US is a major shareholder.

BLACKROCK

Money Market Funds: Potential Capital Solutions

The money market fund industry has come under heightened scrutiny in the aftermath of the worst financial crisis in recent history. The events of 2008, including the historic "breaking of the buck" by the Reserve Primary Fund in September of that year, exposed both idiosyncratic (fund-specific) and systemic (industry- wide) risks associated with money market mutual funds, and gave rise to several reform measures designed to mitigate such risks and enhance the overall value and viability of this important investment vehicle.

While reform efforts have gone a long way toward strengthening the money market fund (MMF) industry and enhancing investor protection, policymakers have made it clear that further changes are in store. In this article, we detail the importance of MMFs in our economy, summarize the regulatory response to strengthen MMFs since the 2008 crisis, and evaluate potential capital solutions under consideration today.

Background: The Role of Money Market Funds

MMFs provide value in the form of liquidity and market-level short-term yields to a broad array of institutional and retail investors. For many investors, this represents a favorable alternative to bank deposits or to the direct purchase of instruments in terms of both liquidity and diversification.

MMFs also play a unique role in the economy by providing short-term funding to commercial and municipal borrowers through purchases of commercial paper and other short-term debt. The flexibility to borrow through short-term debt markets is an important alternative to borrowing from banks for many commercial and governmental entities. In many cases, banks are not equipped nor inclined to provide comparable lending. As such, a great part of the appeal of MMFs is their ability to cost effectively match issuers and investors. In addition, MMFs are an important source of funding for banks that regularly issue commercial paper.

The Regulatory Response

Prior to the financial crisis of 2008, MMFs successfully provided liquidity to the financial markets for nearly 40 years without requiring government intervention. During the height of the crisis and in its immediate aftermath, the concerted actions by policymakers were essential in restoring order and confidence in MMFs in a time of great uncertainty. Following the crisis, regulators moved swiftly to address concerns about the safety of MMFs, including:

SEC Rule 2a-7 Enhancements
The changes to SEC Rule 2a-7 under the Investment Company Act of 1940 were adopted in February 2010 and took effect in May 2010. Strongly endorsed by the industry, the enhancements resulted in more conservative credit quality and maturity standards, more liquid portfolios via requirements for minimum daily and weekly liquidity, as well as enhanced transparency, broader Board powers, and provisions for stress testing.

President's Working Group (PWG) Report.
The President's Working Group on Financial Markets outlined a series of additional proposals related to MMFs in a report titled "Money Market Fund Reform Options," released in November 2010. The PWG tagged the Financial Stability Oversight Council (FSOC), an organization established by the Dodd-Frank Act, with investigating the options more fully, an effort that continues today. The proposals include:

- Floating MMFs' net asset value per share (NAV).
- Creation of private emergency liquidity facilities
- Imposition of mandatory inkind redemptions
- Insurance programs for MMFs
- Two-tier system for MMFs incorporating retail and institutional fund solutions.

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- Two-tier system with stable-NAV funds reserved for retail investors
- Regulation of MMFs as special purpose banks
- Enhanced constraints on "unregulated MMF substitutes"

SEC Public Roundtable
In May 2011, the SEC assembled a panel to address "Money Market Funds and Systemic Risk." SEC Chairman Schapiro and several Commissioners were in attendance, as were six representatives from the FSOC and a wide array of interested parties that included corporate treasurers, institutional investors, academics, industry group representatives and regulators. During the roundtable, several participants emphasized the floating NAV as a key means for limiting MMF-related systemic risk. Institutional investors and industry participants presented the opposing view. While floating the NAV was a central topic, other views were presented, including the idea of requiring sponsor capital and the concept of supplemental shareholder capital.

Industry and academic responses and new ideas.
Issuers of commercial paper, fund managers and MMF investors have universally expressed concerns about the floating-NAV structure for a vehicle that for decades has been differentiated and prized for its stable-NAV feature. In response to the PWG report, and based on subsequent dialogue, a number of new ideas have been proposed. These include: an NAV buffer within each MMF portfolio, a trust structure or other special purpose entity (SPE) outside the individual MMF, a subordinated share class and/or the imposition of redemption fees.

Advancing Structural Change

While significant enhancements have already been implemented, regulators remain focused on further structural forms for MMFs. Before additional changes can be made, it is important that all interested parties agree on exactly what the problem is that requires solving and, to that end, which tools are available and which are off limits. Importantly, the solutions must work for all constituencies, including regulators, MMF sponsors, investors, commercial paper issuers, and U.S. taxpayers.

Defining the Objectives

We would identify two key and universally accepted objectives of any proposed structural change:

- To maintain MMFs as a viable cash vehicle; and
- To strengthen Rule 2a-7 to enable MMFs to better withstand idiosyncratic and systematic risks.

We believe particular attention should be paid to fund-specific risks, including factors related to a fund's credit quality and liquidity, and its ability to withstand acute risks in the event of a systemic situation.

Acknowledging the Constraints

Through the public discussion forums mentioned in the previous section, a number of meaningful obstacles to MMF reform that must be factored into the development of an acceptable solution. Among them:

- The status quo is not acceptable to regulators;
- A floating NAV is not acceptable to investors;
- Access to the Federal Reserve discount window is not available;
- Socialized or shared capital could result in idiosyncratic risk; and
- Segregating retail and institutional investors does not solve the MMF problem.

Capital Solutions: An Overview

Capital solutions to the MMF debate can include multiple structures (or forms of capital) and multiple sources of capital. The figure below shows the full spectrum of possibilities, and a description of each follows.

(Wide Spectrum Of Possible Capital Solutions figure on Page 14*)*

Redemption Fees

Redemption fees could be established to create economic disincentives to redeem. The redemption fee would need to be applied using a clear set of rules. These rules could include a provision for di minimis withdrawals, and could provide for a notice period after which the fee would not apply. Any fees collected from redemptions would be retained within the MMF for the benefit of remaining shareholders. This type of "circuit breaker" would further protect a fund from excessive redemptions.

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Wide Spectrum of Possible Capital Solutions*

Status Quo: May 2010 Rule 2a-7 enhancements are sufficient

Redemption Fees: Institute an economic incentive to discourage runs

NAV Buffer: Establish an NAV buffer (or cushion) within individual MMF portfolios

Subordinated Share Class: Create a new share class to co-exist with common shares

Trust/Special Purpose Entity: House a buffer outside the individual portfolio(s)

Hybrid Approach: Employ some combination of the prior three options

Floating NAV: Eliminate stable NAV and find new market equilibrium

* Capital to be derived from sponsors, shareholders, third parties and/or some combination thereof.

Source: BlackRock

While not eliminating the need for capital, the presence of redemption fee features should mitigate the amount of capital required. Some institutional investors may be resistant to products with redemption fees and the triggering mechanism will be important to their investment decision-making process.

NAV Buffer

Under this scenario, a "buffer" would be established within each MMF by siphoning a small amount of income from the portfolio to be set aside as an NAV cushion. The assumption is that a uniform "fee" would be set by regulators (e.g., 4 basis points). The buffer capital is regarded as an asset of the portfolio and, as such, is calculated into the NAV and results in a higher NAV for the MMF. The siphon would be turned on and off depending on the size of the buffer relative to the pre-determined minimum capital requirement. In other words, the portfolio would stop retaining income when the target buffer is reached. Shareholders of the MMF would "own" the buffer. Although this option appears to be embraced by many industry participants, regulators have signaled that this may be insufficient.

Subordinated Share Class

Under this approach, each MMF would have two share classes: senior and subordinated. The senior class would act much like current MMF shares, with a stable $1 NAV and investment income and dividends based on the underlying portfolio less an amount allocated to the subordinated share class. The subordinated share class would have a variable payout based on a fee charged to the total portfolio and distributed to the subordinated shareholders.

The subordinated share class would have a term and would be subject to one-year extensions up to a 10-year term. If the NAV falls below a threshold (e.g., $0.999), then the subordinated share class would extend for one year. If, at the end of five extensions, the NAV

(Cont.)

still is not above the threshold, the fund would be liquidated with all subordinated shareholders receiving a pro rata redemption amount (something less than $1) regardless of which maturity series they hold.

Given that MMFs have large inflows and outflows, the fund sponsor would need to be able to issue additional subordinated shares and/or redeem subordinated shares to right-size the subordinated share class relative to the overall size of the fund. In the event a fund diminished in size without an NAV decline, the subordinated share class would be subject to a tender (optional redemption) feature.

While this approach sets a market price for the level of risk involved, the structure is quite complex and would require significant infrastructure and expense, as well as the cooperation of the SEC.

Trust (or Special Purpose Entity) Structure

Another approach is to develop a trust or special purpose entity (SPE) structure that would house the money market mutual fund. The SPE would be created to hold capital for the benefit of the MMF. The SPE would, in effect, provide a guarantee to the MMF to top up the NAV to $1 whenever the fund's fair value drops below 0.995. This mechanism would work like a capital support agreement.

The capital for the SPE could come from (i) the fund sponsor, (ii) a fee imposed on the portfolio, (iii) third parties, or (iv) from some combination of the prior three sources. Ideally, the SPE would issue both common and preferred stock. It is expected that the sponsor would hold the common stock of the SPE. The sponsor could choose to issue preferred stock for purchase by third parties to reduce the sponsors' total exposure.

As with the NAV buffer, a fee could be set by regulators and applied uniformly to all funds industry-wide. Unlike the NAV buffer, the capital in this structure would be owned by the SPE, and in the event of a liquidation, the remainder would be returned to the holders of shares in the SPE.

This approach lends itself to combining sponsor and third party capital. In addition, the fee from the portfolio ensures investors are contributing to the cost of a stable value product. These securities would be outside the MMF itself, and they would clearly be "equity" in the SPE rather than "debt" of the MMF. The SPE could issue multiple share classes (i.e., common and preferred) with different rights, enabling the preferred to be more protected and thus should require a lower yield.

Hybrid Solutions

Notably, the proposals outlined above need not constitute an all-or-nothing proposition. A hybrid approach that uses some facet of the aforementioned models could be a desirable solution. Rather than being overly prescriptive, regulators could allow for some market innovation — specifying the minimum amount of capital and timeframe for capital to be in place, and then allowing each plan sponsor to address the problem in a way that best meets its needs. However, the benefits of flexibility need to be weighed against the cost of complexity.

Conclusion

When considering MMF reform, it is important to reflect on the role MMFs play in the overall short-term financing markets for corporations and municipalities and, by extension, the tremendous impact they have on the functioning of our economy. As additional structural change is considered, care must be taken to ensure that the reforms, both individually and collectively, achieve the objective of protecting MMFs and the shareholders who invest in them without inadvertently destabilizing financial markets.

BlackRock has advocated "capital solutions" from the outset of the MMF reform discussions (see February 2010 ViewPoint titled "A Proposal for a Capitalized Special Purpose Entity"), and we are not surprised that many of these solutions remain under consideration today. We welcome the opportunity to continue to engage in finding the optimal solution that would both maintain MMFs as a viable cash vehicle and strengthen Rule 2a-7 to enable MMFs to better withstand risks.

For more detail on this and other related topics, visit: http://www2.blackrock.com/global/home/PublicPolicy/ViewPoints/index.htm

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