



# Investment Perspective

Cash Management

Fourth Quarter 2010

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## Reviewing the Basel III Impact on Money Market Funds

After the markets got knocked to the mat in the second quarter, they got back on their feet and steadied their wobbly knees during the third quarter. U.S. equity market indices rose double-digits during the quarter while the Barclays Capital Aggregate Bond Index had a total return of 2.5%.

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### Basel III

In our previous Investment Perspective, we examined the European sovereign debt crisis and the resulting European Bank Stress Test. While the market's apprehension of these two events has appreciably diminished, the Basel Committee on Banking Supervision has been working on proposals to strengthen the banking sector's ability to withstand severe financial and economic stress. The Basel Committee is composed of banking regulators from a number of industrialized countries with the core membership from Europe, the U.S. and Japan. The first set of Basel Committee rules were released in 1988 as Basel I with the first major revision proposed in June 2004. Basel III is the second major revision to the original set of rules which seeks to increase the level and quality of bank capital, address leverage and introduce a global minimum liquidity standard. These proposals are expected to be ratified at the G20 Leaders Summit in Seoul, Korea on November 11-12, 2010.

Although the proposals are not yet finalized, we believe they represent a significant enhancement to Basel II rules and will strengthen the credit profile of banking institutions. The higher capital ratios would be phased-in beginning in 2013 with full implementation due by January 1, 2019. Broadly speaking, banks' Tier 1 common ratio will increase from 2% to 7% over this period.<sup>1</sup> The proposal also introduces a Liquidity Coverage Ratio and a Net Stable Funding Ratio to promote resiliency of these banks' funding and liquidity profiles during a prolonged credit crisis that would be phased-in beginning 2015 and 2018, respectively. The Liquidity Coverage Ratio requires these firms to hold high-quality liquid assets equal to or greater than 100% of the net cash outflows over a 30-day time frame. The Net Stable Funding Ratio requires sufficient stable medium-term and long-term funding against the assets and activities over a one year horizon.<sup>2</sup> Interestingly, the Basel II rules have not been fully implemented prior to the new proposals and some investors are pressuring banks' to implement the proposals before the required timeframe.<sup>3</sup>

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### Potential impact of Basel III on money markets

Clearly, additional capital to buffer against loss is a credit positive while the Liquidity Coverage Ratio may have a significant impact on the fixed income markets. Banks currently have sizeable portfolios of high-quality short-maturity securities like U.S. Treasury Bills and Agency Discount Notes. However, the proposals will require all potential cash outflows, including an assumption of an immediate 100% draw on all outstanding credit lines, for a 30-day period to be supported by liquid securities appears somewhat extreme.

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<sup>1</sup> Basel III: A significant positive for bondholders, Barclays Capital, September 29, 2010. Used with permission.

<sup>2</sup> Short-Term Fixed Income Market Update, J.P. Morgan, October 13, 2010. Used with permission.

<sup>3</sup> Ackermann Says Investors Want Basel Rules Implemented by 2013, Bloomberg L.P., October 18, 2010.

The market impacts of these proposals could be a substantial decrease in many short maturity debt obligations (such as Commercial Paper, Municipal Variable Rated Demand Obligations, Financial Floating Rate Notes, Asset Backed Securities), heightened demand for short maturity Treasury and government securities resulting in a flat money market curve, and increased competition for deposits that may favor the largest banking institutions.<sup>1, 2</sup>

Potentially, the Basel III proposal's largest impact may come from the added cost of providing credit lines and the Liquidity Coverage Ratio, banks may need to hold high-quality securities equal to or greater than the amount of the offered credit line. The heightened cost of providing credit gives an economic incentive to banks to reduce credit availability which may cause corporations to respond by increasing their cash holdings at the expense of capital investment and hiring at a very inopportune economic time. Additionally, short-term assets such as Asset Backed Commercial Paper ("ABCP") and Municipal Variable Rate Demand Obligations ("VRDO"), which structurally require a bank liquidity facility, may feel the full impact of the increased cost and may see a substantial decrease in their respective markets. Similar to corporate Commercial Paper (CP), these securities provide for a significant amount of financing for corporate trade receivables, consumer receivables and municipal issuers who seek low-cost reliable funding.

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### **The ABCP market**

After declining approximately 66% from the record high in June 2007, the ABCP market has stabilized around \$400 billion since the end of 1Q 2010. This currently represents around 37% of the entire U.S. CP market, substantially lower than the 57% of the U.S. CP market in 2007. The composition of the program types has largely shifted back to traditional bank-sponsored multiseller conduits, representing approximately 70% of market outstandings, with the underlying asset classes closely matching investors' preference for more predictable performance, such as trade receivables and consumer loans. Programs that relied on market-based liquidity with complex structures and conduits with concentrated risk to a single-seller or asset class have been removed from the market.

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### **The VRDO market**

Variable Rate Demand Obligations are long-term, tax-exempt bonds issued by municipalities whose interest rates typically reset on a daily, weekly or monthly basis with an estimate \$390 billion market.<sup>3</sup> VRDOs are issued with long-dated maturities of 20 to 30 years with a put feature that allows an investor to put the bond back to an investment dealer, at par, with any accrued interest. This put feature is supported by a letter of credit ("LOC") and or a standby bond purchase agreement ("SBPA") typically provided by large financial institutions. These credit and liquidity enhancements provide compliance to SEC rule 2a-7<sup>4</sup> and provide for high credit ratings from the respective credit rating agencies.

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### **More supply and demand imbalances**

The heightened costs to support the ABCP and VRDO markets may make these two markets less competitive against term debt (maturity longer than 1 year).<sup>2</sup> As with other recently amended regulations, investors are pushed to carry a high level of very short liquidity while pulling issuers out of the short-term market in favor of issuing longer term maturities. While this promotes a safe cushion individually, they create market imbalances when taken collectively. Fortunately, markets have a way of adapting to change, and we believe they will, as with all newly enacted regulation.

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1 Short-Term Fixed Income Market Update, J.P. Morgan, October 13, 2010. Used with permission.

2 U.S. Fixed Income Weekly, RBC Capital Markets, September 9, 2010. Used with permission.

3 Basel may be Threat to Money Funds, The Bond Buyer, September 23, 2010. Used with permission.

4. Daily liquidity requirements for SEC Rule 2a-7: At minimum, 10% of taxable money market fund assets must be in cash, U.S. Treasury securities or securities that convert into cash (e.g., mature) within one day. Weekly liquidity requirements for SEC Rule 2a-7: At minimum, 30% of all money market fund assets must be in cash, U.S. Treasury securities or other specialized government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week. Credit quality requirements for SEC Rule 2a-7: Limits a money market fund's ability to acquire lower quality "Second Tier" securities by 1) restricting a fund from investing more than 3% of its assets in Second Tier securities; 2) restrict a fund from investing more than one-half of 1% of its assets in Second Tier securities issued by any single issuer; 3) restrict a fund from buying Second Tier securities that mature in more than 45 days.

**An investment in money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a 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 such a fund.**

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