Blogs
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Asset Management ADVocate

Re-Proposed Rule 18f-4: Unfunded Loan Commitments

This post continues our consideration of a carveout from the proposed Value at Risk ("VaR") limitations of Rule 18f-4 for unfunded commitment agreements "because they do not present an opportunity for the fund to realize gains or losses between the date of the fund's commitment and its subsequent investment …." Our last post dealt with commitments to invest in a company's equity. But the definition of "unfunded commitment agreement" would also include a contract "to make a loan to a company." Commenters on the original Rule 18f-4 proposal contrasted these loan commitments with:

> firm and standby commitment agreements, under which a fund commits itself to purchase a security with a stated price and fixed yield without condition or upon the counterparty's demand."

We do not believe the contrast is as stark as these commenters suggest. If our view is correct, we will need to search for additional factors to distinguish these loan commitments from commitment agreements that should be treated as derivatives transactions.

Investment Risks of Loan Commitments

Commenters argued that firm and standby commitments:

> expose the fund to investment risk during the life of the transaction, because the value of the fund's commitment agreement will change as interest rates change."

Contrary to the distinctions these commenters sought to draw, the proposed definition of "unfunded commitment agreement" would include loan commitments that could change in value as interest rates change. First, the proposed definition does not exclude loan commitments having a stated price (e.g., the principal amount of the loan) and a fixed yield. The definition also would expressly include unconditional commitments and commitments that can be drawn at the company's discretion. Thus, a commitment to make a loan "with a stated price and fixed yield without condition or upon the counterparty's demand," which the commenters cited as the distinguishing characteristics of firm and standby commitments, would qualify as an "unfunded commitment agreement" under the proposed definition. Second, these comments implicitly assume that the loans under a commitment would have a floating interest rate, rather than a "fixed yield." This would mitigate the risk that the value of the loan commitment would change in response to general changes in interest rates. The fund would remain exposed, however, to interest rate changes due to the repricing of credit risk, whether generally or specifically with respect to the borrower. The percent added to the reference interest rate, called the "spread," indicates this risk and may change during the term of the loan commitment. Changes in this spread could affect the value of the commitment.

Rule 2a-7 Again

Rule 2a-7's limitation on what is (unfortunately) termed the "weighted average life" or "WAL" of a money market fund's portfolio illustrates the potential effect of a change in credit spreads. As explained in a previous post, Rule 2a-7 indirectly limits commitments made by money market funds by limiting their average weighted maturity ("WAM") to 60 days or fewer. When calculating its WAM, a fund may treat a variable rate instrument as maturing on the date of the next change in its interest rate, provided that the instrument "can reasonably be

expected to have a market value that approximates its amortized cost" following each adjustment throughout its term. This treatment of variable rate instruments leaves money market funds exposed to changes in credit spreads, which may cause the instrument's price to diverge from its amortized cost. To mitigate this risk, Rule 2a-7 limits a fund's WAL to 120 days. Funds calculate their portfolios' WAL using an instrument's final maturity date or, if applicable, the date on which the fund may demand repayment, disregarding any adjustments to the interest rate. Restricting WAL to 120 days limits the potential impact of an increase in credit spreads on a fund's net asset value. As the credit spread is only one component of an interest rate, changes in spreads should be smaller, on average, than changes in general rates. Hence the limit on WAL (which mitigates the risk of changes in spreads) is twice the duration of the limit on WAM (which mitigates the risk of overall changes in interest rates).

Conclusion

We do not think adding the complex definitions of "variable rate security" and "weighted average life" from Rule 2a-7 to Rule 18f-4 is the best approach to defining loan commitments excluded from VaR limitations. Instead, we propose to look for other factors that may be unique to these commitments as compared to commitments that should be treated as derivatives transactions.

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