Funds Prodded To Shed Assets In Derivatives

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Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—Get ready for more of the nation's money-market funds to dump their holdings in derivative securities as two BankAmerica Corp. money funds recently did.

That's because pressure is growing from regulators and others who say the nation's $600 billion money-fund pool is no place for things like a "range floater" or a "dual index note."

Among the skeptics is the Securities and Exchange Commission, which Friday prodded the money funds to get busy and start weeding out their dangerous derivatives.

Mutual-Fund Price Data

Mutual funds are speeding up plans for transmitting more-accurate daily prices to newspapers. Article on page C7.

Barry Barbash, head of the SEC's Investment Management Division, told fund advisers and trustees to form "a plan to dispose" of the securities in "an orderly manner consistent with the interest of the fund's shareholders," in a letter sent to the Investment Company Institute, an industry trade group.

Also Friday, the credit-rating service Standard & Poor's Ratings Group downgraded Wilmington Trust's Rodney Square Fund U.S. Government Portfolio money-market fund to single-Am from triple-Am.

S&P cited the "market price exposure of its holdings of structured notes and certain other variable-rate notes," which

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Money Funds Face More Pressure To Shed Their Derivative Assets

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accounted for about 12% of the $424 million fund as of June 30.

The rating service also placed BankAmerica's Pacific Horizon Government Fund on its CreditWatch list, meaning the fund could be lowered from its current rating of triple-Am. The San Francisco bank-holding company recently disclosed that the fund, along with its Pacific Horizon Prime Money Market Fund, has been infused with $67.9 million to make up for recent derivatives losses.

Derivatives are financial arrangements whose value is linked to, or derived from, the performance of some underlying asset, such as bonds, currencies or commodities.

It is understood that the SEC staff is examining the fund-pricing issues surrounding the BankAmerica bailout of its two money-market funds. Despite derivatives-related losses, the funds have continued to report a steady net asset value of $1 a share. The agency also is expected to study the types of securities in the fund and what led to the infusions. The SEC and BankAmerica wouldn't comment.

People familiar with the funds say they believe that the BankAmerica funds held some "range floaters" – risky securities that don't pay any interest if market interest rates move outside of a specified range. When interest rates surged, the yield on many such securities evaporated.

So far, only a couple dozen funds around the country are believed to have invested heavily in derivative securities. S&P says the securities in question make up only about $5 billion to $10 billion of the $450 billion total in taxable money-market funds. Such derivatives have been added to portfolios by money managers frustrated by low interest rates who were eager to gain any extra smidgen of yield.

"We've completed a review of the industry, and we've seen only a small portion of the total assets out there in this stuff," says Sanford Bragg, an S&P managing director. "Those who are getting out of it are doing the right thing for shareholders."

Currently, the SEC permits money funds to invest in certain floating-rate securities as long as there is a reasonable expectation that they won't fall below face value for an extended period. But agency officials worry that some of the newer derivatives may involve higher risks than money funds should be taking. The recent letter clarifies and reiterates many of the concerns the commission wrote about last year.

"We're not saying they should have a fire sale tomorrow," says Mr. Barbash. "We simply don't believe these are appropriate for funds to hold."

In addition to range floaters, these types of derivatives were mentioned in the SEC letter as inappropriately risky for money funds:

"Capped floaters"—securities on which interest isn't paid when market rates move above a certain level.

"COFI floaters" – securities whose interest-rate reset provisions are tied to an index that materially lags behind short-term interest rates.

"Dual index floaters" – securities whose interest-rate reset provisions are tied to more than one index so that a change in the relationship between these indexes may result in the value of the instrument falling below par, or face value.

"CMT floaters" – securities whose interest-rate reset provisions are tied to long-term interest rates so that a change in the slope of the yield curve could result in the value of the instrument falling below par.

"Inverse floaters and leverage floaters" – securities whose interest-rate reset provisions "are based on a formula that magnifies changes in interest rates."

—Stephen Power contributed to this article.