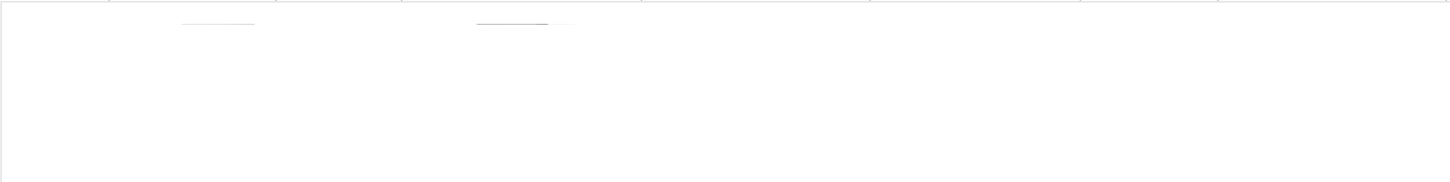

FUND OF INFORMATION

When Funds Lend to One Another

Interfund lending by fund companies can help relieve liquidity pressures, but there is the potential for conflicts.

By LEWIS BRAHAM
November 11, 2017

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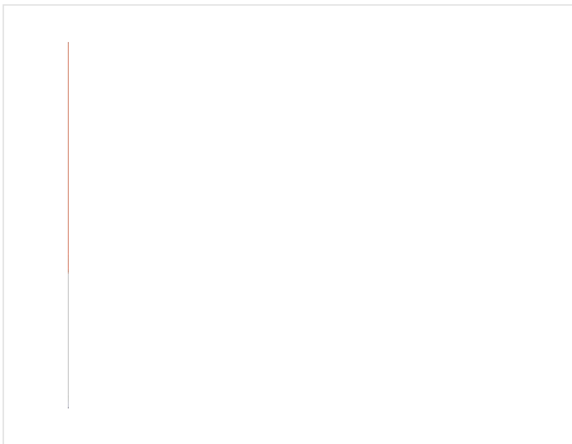

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How would you feel if you invested in what you thought was a safe money market fund and discovered the fund's management company had loaned some of your fund's assets to its junk-bond fund to bail it out of a liquidity crisis?

Under normal circumstances the Securities and Exchange Commission bars funds from making "affiliated transactions," but there's a loophole in the Investment Company Act of 1940 for funds to apply for an exemption to make such "interfund loans." Until recently, few fund families applied for this exemption. None had before 1990. From 2006 to 2016, the SEC approved just 18 interfund lending applications. But since January 2016, the agency has approved 26. Most major fund families—BlackRock, Vanguard, Fidelity, Allianz—now can make such loans. Stiffer regulations of banks, which are now less willing to offer funds credit lines, partly explain the application surge.

Interfund lending can be a valuable tool for borrower funds as there's a liquidity mismatch between fund shares, which can be redeemed daily, and their underlying portfolio securities. This mismatch exists even if a fund invests in highly liquid stocks, as there's a two-day settlement period after the manager executes the sale before the fund

receives the proceeds. The fund investor, meanwhile, receives his cash by the day's end.

That mismatch between when the fund investor can redeem his shares and when the fund is compensated for any security selling is much greater when it's selling illiquid assets, like some small-company stocks or junk bonds. "If I'm holding illiquid assets and you decide to withdraw from my fund, there are two options," says Vikas Agarwal, a Georgia State University finance professor who co-wrote a 2017 study detailing the advantages of interfund lending to borrowers. "Either I have to hold cash to meet your redemptions, which is costly for me because cash does not earn me any return, or I can sell my illiquid assets to give your money back, which is costly too, as I may have to sell them at fire-sale prices. Interfund lending allows fund managers to reduce these costs."

Agarwal's study statistically proved that funds with lending programs invest in more illiquid assets and hold less cash, which helps returns in good times. Also, when they sell assets, they do so at better prices, helping in bad times.

While the benefits of interfund lending are clear for borrowers, for lenders it's another story. "There are several potential conflicts of interest with interfund lending," says Erik Gordon, a University of Michigan finance professor. "Shareholders in the fund not suffering a liquidity problem most likely have been earning lower returns on that fund because its investments are of the sort like Treasury bonds where there's less likely to be a liquidity problem. There's a conflict of interest in seeing those fund assets go across the desk to a fund that is having liquidity problems in order to save the shareholders who were getting higher returns than you were getting because they were taking on higher risk. Effectively, you're now like the government bailing them out from the risks they took." Such lending was proposed as a potential solution to the fire-sale crash that occurred at Third Avenue Capital two years ago when it shut down its distressed debt fund amid liquidity pressures.

IF ANOTHER FINANCIAL crisis occurs, Gordon says some lender-fund shareholders who thought they were safe will be on the hook if riskier borrower funds are unable to pay the loan back. Distressed borrower-fund shareholders will be unhappy to discover there's another fund their fund owes money to while they're struggling to recover. "Oh my gosh, this will be a horrendous maze of lawsuits and [counter] lawsuits," Gordon says. "It will be a bonanza for the lawyers."

There's also a potential conflict of interest in the pricing of such loans. "In the interfund lending applications I've read, the borrowing fund is likely to borrow at a rate lower than it would be charged by an institution such as a bank outside the fund family," Gordon says. "On the other side, the lending fund will make more than it would make if it bought repos." Repos are repurchase agreements—short-term borrowing for dealers in government securities. The repo rate is usually low, currently 1.2%. So say the repo rate is 1% and external banks would lend to a fund at 3%, the interfund loan would be at 2%.

"The interfund lending program has very specific requirements as to what kind of rate you must lend," says Lu Chang, chief risk officer at Angel Oak Capital Advisors, which received SEC approval for its three funds to participate in an interfund lending program this April. "No fund should receive a better interest rate to the disadvantage of another fund. The lending rate must be more favorable for the lending fund than the repo rate." But Gordon says the repo is a poor benchmark. "If you're in the lending fund [and] the actual market price for that loan is 5% from a bank for a line of credit, why are you getting paid 4%?" he says. "Just because the repo rate is 3%? But we're not buying repos. We're getting 4% for something the market says we should get 5%."

Chang says fund directors ensure that loans are mutually beneficial. "If there's no benefit to the lending fund and it's just to try to rescue a distressed fund, such lending would not sit well with the board."

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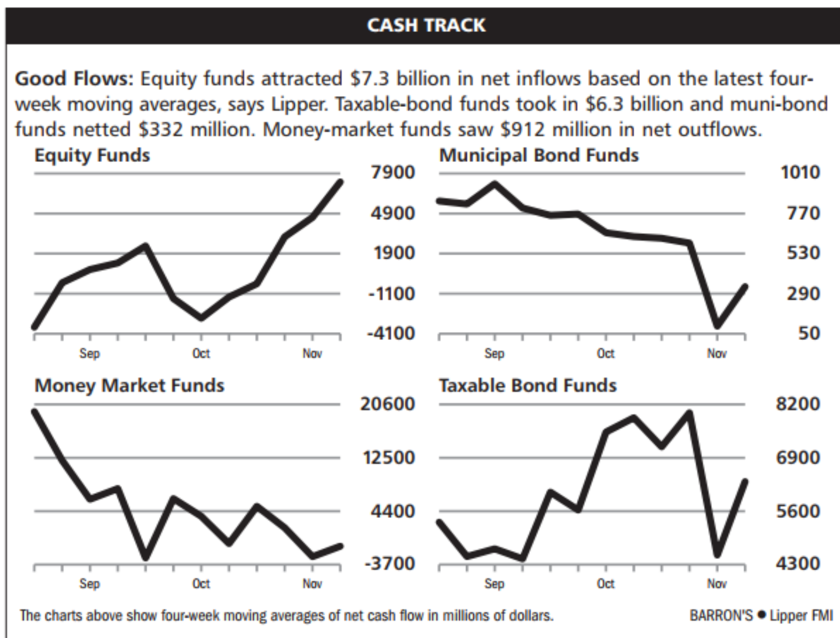

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