FedFin Client Report

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U.S. Advances Go-It-Alone, Structural MMF Reform

Client Report: MMF16

Executive Summary

Late yesterday, the President's Working Group on Financial Markets (PWG) issued an unusual report signaling agreement by Treasury and the FRB, SEC, and CFTC on the urgent need for changes in the MMF sector to prevent systemic "dash-for-cash" events such as the most recent March crisis. While outgoing statements from Treasury, the SEC, and CFTC, the PWG report nonetheless establishes a strong platform for rapid U.S. action even as the FSB continues work on its "holistic" agenda (see FSM Report **NBFI**). Although some asset managers expected the SEC to continue to balk at structural MMF change, it concurs not only with the PWG's assessment of imminent systemic risk in the absence of change, but also with the conclusion that risk is so acute that it may warrant a smaller prime/tax-exempt sector and any resulting short-term funding challenges for foreign banks. As we have noted (see *Client Report* **REFORM200**), the Fed is also deeply concerned with FBO reliance on short-term wholesale funding.

As discussed in this FedFin report, the PWG paper's conclusions about MMF risk are clear, but next steps are laid out as options, not express recommendations. Even so, the ten options are not only often novel – e.g., a new bank charter expressly for MMF-liquidity support – but also a clear rebuttal to many other options. For example, the PWG expressly rejects industry arguments that March's MMF problems were second-order effects of broader Treasury-market illiquidity for which MMFs cannot be held responsible. Options also include some policies – e.g., capital buffers and sponsor-support requirements – long considered anathema to the SEC and global securities regulators. Indeed, given IOSCO's wary approach to the FSB report, the PWG report also signals U.S. determination to move forward quickly with MMF reforms regardless of the outcome of FSB recommendations. Because many funds are dollar-denominated, the U.S. will thus set the global agenda instead of being set by it. This report thus lays out the PWG's options, options on which we expect advocacy quickly to begin very early next year.

Analysis

As noted, the background and 2020 assessment in the PWG report dissents from recent industry arguments that MMF illiquidity resulted from other factors (e.g., dealer-bank illiquidity)

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or that MMF runs resulted from imminent gates, not investor fears of liquidity fees. The paper acknowledges that prime and tax-exempt MMFs were not the sole cause of investment-fund systemic risk in March, but they were disproportionately affected and had adverse impact across many other funds at the time. The PWG report not only emphasizes near-term systemic risk, but also increased moral hazard in the wake of the Fed's March MMLF backstop to buttress its call for action.

The PWG also concludes that post-2008 reforms were insufficient. It does not provide extensive detail on each of the options it says requires further consideration, instead laying out pros and cons for each and discussing how they should be evaluated in terms of offsetting objectives and costs. In general, the PWG's goals are to decouple market behavior from regulatory incentives and increase the role of private capital, what global regulators have called "self-insurance." The PWG is also, as noted, determined to end moral hazard, looking at some options (e.g., floating NAVs) as tools to ensure better investor discipline. The paper also notes that smaller prime and tax-exempt funds may "not be inappropriate" given the serious risk they pose.

The paper's policy options are said not to be mutually exclusive and have varying efficacy. Notably, the report updates prior thinking by assessing options under lower-for-longer scenarios without at the same time considering the stress that prolonged ultra-low rates could immediately pose across the MMF sector. The PWG recognizes that its policy options may also extend farther than prime and tax-exempt MMFs, noting implications for government MMFs, banks, and the financial-market sector in each of the report's pros and cons for each option. These are:

- ending ties between MMF liquidity and fee/gate thresholds;
- reforming redemption gates;
- minimum balance-at-risk standards;
- money market fund liquidity management changes;
- counter-cyclical weekly liquid asset requirements;
- floating NAVs for all prime and tax-exempt funds;
- swing pricing;
- capital buffers;
- mandatory liquidity-exchange bank membership. The PWG details how this might work through what is the equivalent of a special-purpose, regulated bank which might gain Fed access and come under capital requirements and other conditions; and
- sponsor-support requirements.

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