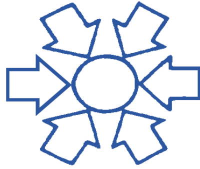

GSE Activity Report

Thursday, July 8, 2021

Govvies, Primes, and the Agency Market

Summary

Our recent in-depth analysis details the range of options proposed by the Financial Stability Board for MMF reform. Here, we assess what this means for Fannie, Freddie, and the FHLBs. In short, it depends on what these GSEs turn out to be but as long as they are agencies, MMF reform should ensure low-cost funding and a big edge on everyone else, many banks included.

Impact

Unlike most of its pronouncements, the FSB's MMF consultation lays out the pros and cons of numerous options for national decision-making rather than a specific framework deemed optimal for cross-border finance. This tracks the analysis issued earlier this year in the U.S. by the President's Working Group on Financial Markets (PWG), but the FSB adopted this not only because its consultation is preliminary, but also because the global body charged with implementing MMF reform – IOSCO – wants a very light touch. The FSB doesn't, but it knows its limits or, at least it's learned them due to the decade of fruitless asset-management reform efforts that preceded this proposal.

However, light-touch in the global arena doesn't and won't mean a feathery U.S. approach to MMFs. The FSB is chaired by Fed Vice Chairman Quarles who must defer to his global colleagues on these consultations, but in the U.S., not so much – indeed, the SEC already has its MMF-reform work well under way thanks to a heavy push from Secretary Yellen, Jay Powell, and Quarles along with a strong desire to intervene on the part of its new chairman, Gary Gensler.

Given Quarles' equivocal positions, the U.S. will not go beyond the options blessed in the final FSB report, but it can and will "goldplate" the ones it selects in concert with, over time, renewing work to bring the biggest fund sponsors into the systemic-designation framework.

The Fed has been on the MMFs' case since 2008, losing a battle to the SEC in 2013 it doesn't want to repeat after the 2020 crisis forced yet another massive Fed intervention to backstop MMFs along with so much else. And, even if the Fed were feeling feathery, the fact that its overnight reverse repo program (ON RRP) is trending over a trillion means its own exposure to the fund sector puts it in harm's way absent structural reform.

The result of MMF reform is thus likely to be structural redesign, principally targeting institutional prime funds in ways that boost government funds (govvies). Anticipating this, govvies are likely also to face new rules, but the bullseye is on institutional prime funds. Although the FSB is not prescriptive with regard to the reform options it prefers, it is unilateral in one key demand: that prime funds, especially institutional ones, be redesigned either to be closer to true cash equivalents (in which case they would also buy more agency paper) or be clearly funds in which investors recognize the potential for both

© 2021 Federal Financial Analytics. All Rights Reserved.

redemption and credit risk much as they now do (more or less) for bond funds.

Making prime funds cash-like is such a formidable undertaking and brings them so close to being govvies that the most likely course of action, especially in the U.S., is to pick reforms that build buffers between prime-fund holdings and the investor. Our in-depth analysis lays out what these are and how they might work; suffice it to say here that all are expensive. While neither the FSB nor SEC is likely to go as far as some at the Fed have urged – i.e., banning institutional prime funds – reforms will likely so redefine them that the foreign banks and other investors dependent on prime funds will take a cost hit and head to govvies, CDs, dollar-denominated core deposits when they can find them, or the repo market.

Outlook

Comments are due to the FSB by August 16. The SEC has a great deal on its plate and, even if it didn't, it co-chairs this global effort, making it incumbent on it to act more or less in parallel to it. However, the G20 finance ministerial later this week will press for MMF reform and the Fed wants it ASAP and as tough AP in the U.S. We thus expect concrete proposals in the early fall and market realignment beginning shortly thereafter.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

© 2021 Federal Financial Analytics. All Rights Reserved.