Global MMF-Resilience Standards

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Impact Assessment

- MMFs are set for structural reform, but national actions could vary markedly in the absence of a defining global approach. Fragmentation and regulatory arbitrage might result, but home/host factors would be given full scope without endangering FSB disapproval.
- Some MMF reforms could significantly increase use of substitute products. Bank deposits might rise and/or short-term bond funds grow, with significant financial-stability impact depending on final market configuration, any accompanying bond-fund reform.
- Institutional prime MMFs are targeted, but reforms could also occur for government, retail-prime funds, especially if institutional-prime changes redefine current cash-like properties.
- CP, CD funding costs could rise, adversely affecting the corporate-finance construct, raising bank-funding costs, and perhaps increasing repo-market activity with adverse financial-stability impact.
- FBO funding costs could rise and FRB concerns about the need for liquidity regulation concomitantly fall.

Overview

As promised late last year when it addressed nonbank financial intermediation (NBFI),[1] the Financial Stability Board is seeking comment on ways to reduce the risk that money-market funds (MMFs) succumb to runs under stress or, as occurred in both 2008 and 2020, require taxpayer backstops. Rather than laying out a specific

[1] See **NBF**I, *Financial Services Management*, November 17, 2020.

reform proposal, the consultation describes a series of options largely aimed at non-public MMFs (i.e., prime funds). Echoing some in the U.S., the consultation mentions in passing barring these funds, but options on which comment is sought would instead change the business model. Some of these options are so structurally significant that they might shutter some prime funds. The overall construct of MMF sponsors could also change if, for example, the FSB advances proposals for capital buffers and nations then adopt them. Although this could significantly raise MMF costs, banks are likely best positioned to absorb them. Many proposed changes would also reduce and perhaps even eliminate the equivalence institutional prime funds now enjoy to cash, increasing reliance on public (i.e., government) funds. Foreign banks depending on U.S. prime funds for dollar funding would see their funding costs rise but FRB concerns about their liquidity under stress might also ease.

Impact

Although the NBFI report was unequivocal in its view that MMFs and especially prime MMFs pose systemic risk, this consultation takes a more cautious stance. While it details many of the risks outlined in the prior report, it emphasizes the need for jurisdictions to vary responses based on national-market characteristics. The FSB more typically sets standards in broad, but still specific, terms that create a framework in which nations may be judged for adherence and chastised for failure to come at least close in standards, if not also practice. The FSB's circumspection here may reflect ongoing industry opposition to structural MMF reform reflected in the position taken by the International Organization of Securities Commissions (IOSCO), the global body specifically charged with asset management and, thus, MMF standards.

It remains to be seen if the final FSB report will continue this guarded path or take the firmer tone not only of its own initial NBFI report, but also that in statements on MMFs from finance ministers, central bankers, and heads of state at the G7 and G20. Broad discretion in either FSB or IOSCO prescriptions could lead to a patchwork of MMF reforms and, in some nations, none at all. Regulatory arbitrage and market fragmentation would then result unless recognition of national circumstance did not provide refuge from the costs attendant to the approaches demanded in other jurisdictions or the importance of dollar funding makes U.S. rules the de facto global standard.

Indeed, the U.S. is not likely to be among the nations that leave MMFs as they are. In January, the President's Working Group on Financial Markets (PWG) issued a report laying out its own set of MMF-reform options.[2] Although released at the end of the Trump Administration, it was cleared with incoming Secretary Yellen and represents the continuing views of the FRB. The Securities and Exchange Commission has come under a new chairman not then on the PWG, but the Commission presaged Gary Gensler's arrival with a request for views on MMF reform. This has laid a platform for SEC changes which Chairman Gensler has made clear he plans to advance while the FSOC considers the parallel question of bond-fund reform.

[2] See *Client Report* **MMF16,** December 23, 2020.

Although it is unclear how the SEC will proceed, it is notable that SEC officials co-chaired the FSB committee that issued this report. The Commission is thus unlikely to advance the options (see below) found to pose significant financial-stability risk and those said to benefit banks may also face tough-going. Traditionally, the Commission has been very mindful of MMF business considerations, essentially defying FSOC in 2013 to craft rules focused on redemption thresholds.[3] The FSB report now takes a particularly dim view of this and the SEC is thus unlikely to retain its current approach or agree with U.S. industry comments discounting the need for MMF-specific reform. The FSB report does provide for additional, less structural changes both to MMFs and short-term funding markets, but these are set as ancillary -- not substitute -- actions.

FRB Gov. Brainard has also spoken well of structural MMF reform options as well as of the swing pricing that seems less promising in the U.S. given the longstanding discussion without U.S. action. Swing pricing is not favored by the FSB analysis.

MBRs and/or capital buffers may get more favorable SEC consideration in light of this report and Fed thinking. However, MBRs are considered challenging to compute and of uncertain value under acute stress. Capital buffers will surely be strongly opposed by many U.S. MMFs due to their cost, but the FSB paper does suggest ways to reduce this in terms of both the capital structure and allowing a fund sponsor to provide this capital. When banks are sponsors, this backstop would in turn generate a capital charge for the parent company, an approach the Fed would support in part to recognize the support two banks provided to troubled MMFs during the 2020 crisis. Any such charge would also alter the capital equation now determining whether large banks subject to the supplementary leverage ratio prefer deposits or MMF investments, likely in favor of deposits. Even so, banks are likely better positioned than other sponsors to obtain capital buffers or provide them should the FSB sanction this.

As noted below, national discretion is in part to be based on whether a jurisdiction wants its MMFs to be cash-equivalent or investment vehicles. Institutional prime funds sit squarely between these objectives, having significant cash-like value but posing the investment-like risks that lead to redemption runs. The FSB's analysis frequently and frankly assesses the extent to which its options position a fund in the cash/investment spectrum, making it clear that virtually all of its reforms would move institutional prime funds to one side or the other with resulting investor, sponsor, and financial-stability trade-offs. As noted, at least one U.S. official (at the Federal Reserve Bank of Boston) has suggested that institutional prime funds need not be allowed. The PWG report does not go this far and it seems unlikely that FSOC and the SEC now will do so, but these MMFs may be the most significantly restructured, likely making them more cash-equivalent subject to an array of standards designed to ensure cash-like liquidity under even acute stress.

One way to do so for banks has of course long been via access to a central bank's liquidity window. The PWG showed considerable interest in a special-

[3] See *Client Report* **MMF11**, May 5, 2013.

purpose bank that would provide fund with liquidity and in turn have access to its central bank, but the FSB does not favor this idea. A brief analysis mentions principally how this might "institutionalize" moral hazard.

If institutional prime funds lose some or all of their cash equivalence by virtue of the final package of national reforms, then banks dependent on this funding source would face challenges funding themselves in affected currencies. The most important of these is of course the dollar, with the FSB report detailing how foreign banking organizations (FBOs) in fact rely heavily on dollar-based funds. A switch to government funds or development of alternative dollar-based funding channels would surely raise FBO funding costs, but it would also reduce the liquidity risk behind the MMF redemption runs that led the Fed to intervene so massively in this market in March of 2020. Alternative funding sources less prone to liquidity risk might allay this concern and persuade the Fed to abandon plans to address it with US. capital and liquidity standards on FBO branches and agencies.[4]

Much FSB analysis of bank standards after the 2008 crisis failed to factor the implications of bank costs or market exit on the development of what came to be called "shadow banks" now dubbed NBFIs. This analysis does not repeat this analytical error, instead assessing the extent to which new MMF standards could create MMF substitutes such as bank deposits and government funds. Assessing a key assertion opposing certain reforms – that MMF rules will adversely shrink demand for non-sovereign debt -- the FSB concludes that this did not occur when prime funds were regulated in the U.S. and that alternatives are less prone to systemic risk. Although bond funds might also be MMF substitutes and raise significant risks of their own, these risks are said to be less significant than those associated with prime funds because bond funds are less likely to be used for cash management. Direct investment is not seen as a likely MMF substitute.

What's Next

The FSB released this consultation on June 30; comments are due August 16. A final FSB report is due in October.

As noted, this consultation is more a compendium of possible options than a statement of what the FSB believes probable or desirable. The extent to which it guides national jurisdictions depends on whether the final report is more prescriptive. However, even then it is likely to retain language telling nations that different options can be appropriate for different objectives, objectives that are squarely the prerogative of jurisdictions to set. Different remedies or packages of them are to be considered based on whether the goal is to make MMFs more cash-equivalent or investment-comparable, although nations are also told to keep cross-border considerations clearly in mind regardless of their preferred objective.

4 See *Client Report* **REFORM200,** December 16, 2020.

Analysis

A. Redemption Constraints

Options here include:

- swing pricing, anti-dilution levies, or similar pricing designed to offset first-mover advantage. However, determining liquidity costs is likely to prove complex and opaque, requiring regulatory pricing standards for this option to prove effective. Further, redemption fees might need to be very high to offset a dash for cash unless the prospect leads to ex ante investor diversification;
- minimum balance at risk (MBR), creating a trade-off between liquidity and principal preservation. The FSB concludes that MBRs are fairer than swing pricing but an uncertain barrier to large redemptions under acute stress. MBRs might also lead investors to prefer substitutes, especially if accounting rules are problematic, and create significant operational challenges. MBR would also reduce the appeal of MMFs for investors seeking cash-like instruments, likely increasing demand for bank deposits and government funds, enhancing stability but increasing funding costs and liability-market concentration; or
- a capital buffer likely structured in a fashion more akin to TLAC than traditional capital.[5] Although a capital buffer would reduce redemption incentives under ordinary market conditions, it would likely prove insufficient under severely-adverse scenarios, with buffer sizing a challenging problem based in part on what level of loss it is meant to absorb. Although buffers would be costly, this cost would be higher for riskier MMFs and thus be a risk-reduction incentive unless the fund manager finances the buffer. Higher MMF costs could lead investors to choose higher-yield MMFs or substitutes (e.g., bond funds) might raise additional stability concern.

The FSB also notes other options in less detail. These include:

- allowing sponsors to backstop their MMFs, raising resilience and inter-connectedness concerns. This approach would also likely favor banks, increasing concentration; and
- the establishment of a facility such as the Liquidity Exchange Bank noted above. The FSB notes it is concerned not only with moral hazard, but also because it says the idea is untested.

B. Threshold Effects

Options also include policies to refine redemption or other thresholds so they do not on their own spark run-like behavior:

- no tie between redemption thresholds and fees or gates, with funds triggering fees or gates at will. The FSB notes that this would reduce first-mover advantage and run risk, as well as ensure use of liquid assets to meet draws.

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5 See **TLAC8**, *Financial Services Management*, July 17, 2017.

However, funds would still be susceptible to large redemption runs under acute stress, with the 2020 experience also suggesting that the presence of fees/gates did not meaningfully drive investor behavior. MMF discretion might also lead to stigma concerns or contagion risk. This option would have little impact on MMFs and might even draw funds to them from substitute cash equivalents;

- requiring regulatory approval prior to imposing fees/gates, an option found to be even less effective than discretionary redemption; or
- counter-cyclical liquidity buffers, with this possibly applicable to all MMFs, not just prime funds. Little is said about this and it thus seems an unlikely choice.

C. Short-Term Funding Market Reform

The FSB believes that MMF reform could be accompanied by changes to short-term funding markets in concert with other MMF actions such as:

- robust MMF risk management and supervisory monitoring;
- stress testing based on common scenarios; and
- enhanced transparency in terms of both regulatory reports and public disclosures.

The report also notes the need for greater transparency in the CP and CD market.

D. Request for Comment

Views are solicited on issues such as:

- vulnerabilities requiring reform and reform's proper focus;
- resilience options and any additional courses of action;
- ways to differentiate government from prime funds;
- benefits of risk-management reforms as a complement to MMF reform, along with the need for additional ancillary changes;
- whether MMF reform should be aligned across jurisdictions and/or if there is a need at least for minimum standards to avoid fragmentation and regulatory arbitrage;
- other measures to enhance the resilience of short-term funding markets;
- reconciling cash-management use of MMFs with financial stability; and
- any additional considerations.