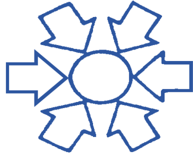

Global MMF-Reform Options

Cite

Financial Stability Board (FSB), Final Report, Policy Proposals to Enhance Money Market Fund Resilience

Recommended Distribution

Asset Management, Treasury, Policy, Legal, Government Relations

Website

https://www.fsb.org/wp-content/uploads/P111021-2.pdf

Impact Assessment

- Global regulators have narrowed down MMF-reform options, with action now left to national regulators. Some may well do little to nothing, creating regulatory-arbitrage opportunities if offshore dollar-equivalent products expand or investors are willing to accept foreign-exchange risk.
- FSB action lays the groundwork for U.S. standards, likely even if there are little or different ones in other key markets.
- Many FSB options increase the odds that prime institutional funds will shrink, strengthening MMF-substitute products such as bank deposits and direct CP/CD offerings.
- If banks have capital flexibility to deploy new funding, then longer-term financial intermediation and resulting growth might ensue.
- Attractive MMF substitutes may also include open-end funds, increasing systemic risk unless ongoing national/global efforts to address these also advance.
- Although many options are assessed, the FSB appears most supportive of asset-eligibility restrictions to reduce MMF illiquidity. This would also increase the appeal of government MMFs as prime-fund alternatives.
- Regulators may also advance indirect MMF standards designed to limit inter-connectedness and thus contagion risk. Many of these will be executed through banks due to greater regulatory authority and certainty.

Overview

Global regulators have now finalized a framework on which national regulators may base the reforms they deemed necessary after the pandemic

©2021. Federal Financial Analytics, Inc.

sparked profound disruptions in this sector.[1] However, as with the FSB's proposed approach,[2] the final framework sets few parameters for jurisdictional action beyond a strong plea for action of some sort that would meaningfully address the redemption and/or liquidity risk the FSB continues to believe presents a threat to national and even global financial stability.

Impact

The final report has a slightly-revised list of what are called "representative options" – i.e., those the FSB thinks most viable – compared to the proposal. Still, little of substance changed in the final report because the Board found that comments on the proposal had little to offer on option choice, action, or prioritization. Given the final list of very different options for different risks, national policy-makers have wide latitude and may ultimately find themselves too perplexed to act or stalemated by offsetting interests and concerns. Many of the final options are accompanied by daunting analyses of unintended consequences. This is true even of the option – eligible-asset restrictions – about which the FSB expresses the fewest qualms even though these options are among the most significant in terms of resulting structural and strategic change. Although the FSB report is emphatic in reiterating that MMFs are subject both to redemption and illiquidity risk, it also says that the extent of this risk and its configuration varies significantly by national market conditions as well as in MMF categories. Non-public MMFs, known as prime funds in the U.S., are said to pose the greatest systemic risk, but the options differentiate among prime and government funds only in certain options, not in the FSB's general framework. Thus even government funds could be subject to reform in nations that deem aspects of their configuration of concern, with relatively mild revisions addressing redemption risk targeted at "govvies" and stiffer structural changes aimed at prime funds.

As the FSB stipulates, virtually all of its representative options would increase investor cost and the appeal of substitute products. As detailed below, substitutes vary by option but most alter the comparative advantage of bank deposits and direct commercial paper (CP) and certificate-of-deposit (CD) offerings. In nations where MMF reforms proceed, banks could thus gain new funding at lower cost, with this promoting longer-term financial intermediation to the extent banks have the capital needed to increase their assets. Asset increases could also heighten concentration and systemic risk, although the FSB discounts the latter concern because of its confidence in big-bank regulation.

What's Next

The FSB released this final report on October 11. Shortly thereafter, the Group of Twenty's finance ministers and central bankers issued a communique that, while strongly endorsing the report and calling for action, made clear that jurisdictions have wide discretion to adopt their preferred approach.

In addition, the FSB plans to work with IOSCO to review how nations implement MMF reforms, finalizing a stock-taking by the end of 2023 followed in

[1] See *Client Report* **NBFI**, November 17, 2020.

[2] See **MMF17**, *Financial Services Management*, July 7, 2021.

©2021. Federal Financial Analytics, Inc.

2026 with an assessment of the effectiveness of national MMF-reform efforts. IOSCO will also revisit its 2012 MMF guidance,[3] perhaps issuing conclusions in concert with the 2023 FSB evaluation. In addition, the FSB and IOSCO will continue work on open-end funds.

As in the proposal, the FSB also states here that MMF work should proceed in concert with stress-testing and transparency standards for short-term funding markets and their participants along with changes to improve the structure of short-term funding markets by reforming liquidity. However, the FSB is clear: action on these additional concerns does not obviate the need for MMF-specific action.

In the U.S., the SEC has sought general comments on MMF reform, with Chairman Gensler making clear that new standards remain a priority.[4] Treasury Secretary Yellen also cited MMF and open-end fund risk as top systemic concerns in recent Congressional testimony,[5] making clear that FSOC action is also possible.

Analysis

In addition to the options detailed below, the final policy statement outlines issues jurisdictions should consider as they decide among them. These pertain not only to current MMF rules and markets, but also to how regulators could combine MMF-specific standards with others to create a broader set of systemic-risk buffers. The Financial Stability Oversight Council began work on these in 2016,[6] and may well return to this issue as the SEC advances MMF-specific standards based on the FSB's final statement.[7]

A. Redemption Risk

Options to reduce destabilizing redemption risk include:

1. Investor Redemption Risk-Shares

If jurisdictions prioritize risk-shares to reduce redemption risk, they may choose among:

- Swing Pricing: This can be accomplished by temporary NAV adjustments or equivalent liquidity fees or anti-dilution levies. However, swing pricing must be implemented to prevent runs and impose full costs on to redeeming investors. Doing so presents an array of challenges without prior regulatory standards, but triggering swing pricing without cliff effects is challenging. Swing pricing may also not deter investors in need of cash and may not prove compatible with key MMF features (e.g., same-day

[3] See **MMF**8, *Financial Services Management*, November 2, 2012.
[4] See *Client Report* **INVESTOR19**, October 5, 2021.
[5] See *Client Report* **REFORM208**, September 28, 2021.
[6] See **ASSETMANAGEMENT4**, *Financial Services Management*, June 30, 2016.
[7] See *Client Report* **INVESTOR19**, October 5, 2021.

© 2021 Federal Financial Analytics, Inc. All rights reserved.

settlement). Resulting shifts out of MMFs to bank or other cash-equivalents might increase market stability.
- Minimum Balance at Risk (MBR): The FSB views this as a material barrier to first-mover advantage, especially in the event of potential credit risk to fund assets. However, MBRs would not reduce liquidity-driven runs, have significant operational challenges, force MMF-restructuring, and pose accounting questions. They might also increase interest in MMF substitutes and increase financial stability at some cost to investors.
- Capital Buffers: As with MBRs, capital buffers address credit risk, but likely not also liquidity-driven runs. Sizing buffers is also problematic and their cost could lead to industry concentration. Were fund managers to post the buffer, risk-taking incentives might increase; if buffers are provided by outside investors, then risk-taking or cost to investors would ensue.

Additional options here include:

- MMF-sponsor support, an option that may pose risks if funds cannot provide support or doing so threatens the sponsor. MMFs with bank sponsors would likely gain a market edge at cost to inter-connectedness and concentration; and
- external liquidity support, with the FSB here expressing considerably more hesitancy about the idea of a Liquidity Exchange Bank than the initial proposal.

2. *Threshold Effects*

Gates, fees, or other thresholds may on their own spark redemptions that then pose systemic risk. Options to address these include:

- Ending Links Between Regulatory Thresholds and Fees or Gates: The FSB thinks large redemptions might still occur, with this option also posing stigma and other risks with regard to illiquidity mitigation.
- Stable-NAV Removal: Although this eliminates at least some first-mover advantage, it would not have significantly reduced MMF risk in March of 2020. As flexible NAVs could also reduce MMF cash equivalence, substitutes would gain. This would reduce systemic risk but increase funding-source cost and concentration.
- Alternatives: Options to delinking thresholds deemed possible but still less desirable include requiring regulatory permission to trigger fees and gates after threshold breach and counter-cyclical liquidity buffers.

3. *Large-Redemption Mitigation*

This would be accomplished by reducing MMF liquidity transformation through options such as:

- Eligible-Asset Limitations: This would reduce, if not eliminate, first-mover advantage and – large redemptions might still occur – their risk would be considerably less. However, CP and CD issuers might be challenged to find new investors and rollover risk would increase across many short-term funding options. Investors would likely shift to substitutes with generally positive systemic-risk impact unless significant funds shift to

©2021. Federal Financial Analytics, Inc.

short-term bond funds. Alternatives to this option are an overall restriction only to public debt, MMF-specific liquidity buffers, liquidity-based redemption deferrals, or redemptions in kind; the report details objections to each of these variations.

- Additional Liquidity Requirements, Escalation Procedures: This option is modelled on bank liquidity requirements with a new tie to escalating redemption restrictions. Stigma and spillover effects are problematic and regulatory thresholds would remain significant investor concerns, but there would be positive effects reducing systemic risk.

B. Broader Reforms

As noted, the FSB wants MMF reform tied to broader changes to short-term funding markets. The Board recommends these as additional action items but not as substitute to reform, making it clear that action – e.g., MMF sponsor and/or regulatory stress testing, new disclosures – will not suffice in the absence of direct MMF reform implementing at least one of the preferred options described above.

Similarly, CP and CD market reform is desirable along lines laid out in the paper but also does not suffice on its own.

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

© 2021 Federal Financial Analytics, Inc. All rights reserved.