FOCUS · The reform of the money funds market in the US

On 14 October the latest reform came into force of the money funds market in the US (MFM hereafter), the most ambitious for the last few decades. One example of the importance of the changes involved in this new regulatory framework is the considerable rise in short-term private financing costs, both corporate and for the financial sector. Since January 2016, the 3-month Libor in dollars and yield on 3-month commercial paper have risen by 30 bps to 0.94% and 0.88%, respectively.

Before detailing the reform of the MFM regulatory framework and assessing its impact, we first need to briefly review how this market works and show just how important it has become for the US financial sector to function properly.

Money market funds (MMF hereafter) are investment vehicles that invest in short-term securities with high liquidity and ratings. Securities that meet these requirements are, for instance, Treasury bills, some corporate bonds, certificates of deposit and repos. The volume of MFMs is considerable: 2.9 trillion dollars in September 2016, representing close to 16% of GDP in the US. With regard to their type, there are two broad categories: government funds, which invest in government securities and agency debt, and prime funds, which principally invest in debt instruments issued by companies and financial institutions. Both of these categories are classified, in turn, according to the investor type: institutional or retail.

Broadly speaking, MMFs have two functions. On the one hand they offer a savings product with a similar level of liquidity and security as bank deposits but slightly higher yields. In fact, MMFs fix a stable net asset value (NAV), normally one dollar per share, even when their market value is lower. Their capital can also be immediately redeemed. On the other hand, these investment funds have become an important source of liquidity for money markets. According to IMF estimates, prime MMFs cover 35% of the short-term gross borrowing needs of US banks.

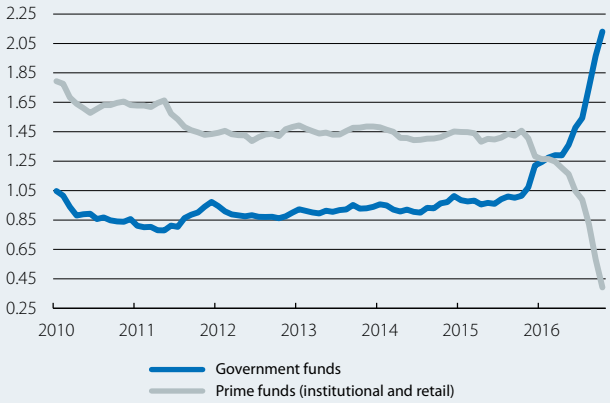
As these funds have become increasingly important providers of finance, fears have also increased of them becoming a potential source of financial instability. In this respect, one of the scenarios that most concern the US capital market regulator, the SEC, is a shock occurring that fuels a sudden, widespread rise in requests to redeem MMFs, as this would have serious consequences for the stability of the financial system in general and, ultimately, for the economy as a whole.

This is precisely the scenario the latest reform of the MFM regulatory framework hopes to prevent. Under the new regulatory requirements, prime MMFs from the institutional segment must leave the fixed NAV system and adopt a floating NAV one that reflects the market value of the securities in the fund. In addition, prime funds (both institutional and retail) can establish fees for redeeming funds of up to 2% and temporarily suspend redemption during periods of financial stress. Government MMFs are exempt from these new regulations.

The impact of this MFM reform on the US money market has been as stealthy as it has been intense. With the aim of avoiding fluctuations in NAVs and potential fees and restrictions on redeeming funds, there has been an exodus of over 1 trillion dollars from prime funds to government funds. This has led to a considerable de facto reduction in the demand for corporate and financial bonds. As a consequence, bank and corporate short-term financing costs have seen notable rises in the last few months. Although the readjustment of flows between money market funds can now be deemed to be over, these costs are unlikely to return to their levels of a few months ago given the structural nature of the changes in the regulatory framework. In the short term, the tightening up of financial conditions resulting from this process may cause temporary tensions in some banks or companies with a greater dependence on MFMs. However, this should not discredit the progress made by adopting these measures, both in terms of how they improve the transparency of MMFs and also help to mitigate systemic risk.

US: assets in money market funds by type

(Trillion dollars)



Source: *CaixaBank Research, based on data from Bloomberg and the Federal Reserve.*