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ICI VIEWPOINTS

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Money Market Fund Reforms Combine with Bank Regulations to Boost Interest Rates

By Sean Collins

Third in a series on money market funds.

As detailed in the previous *ICI Viewpoints* in this series, the new Securities and Exchange Commission (SEC) rules for money market funds induced a drop in the assets of prime and tax-exempt money market funds of $910 billion since January 2015 and a roughly comparable $872 billion rise in the assets of government money market funds.

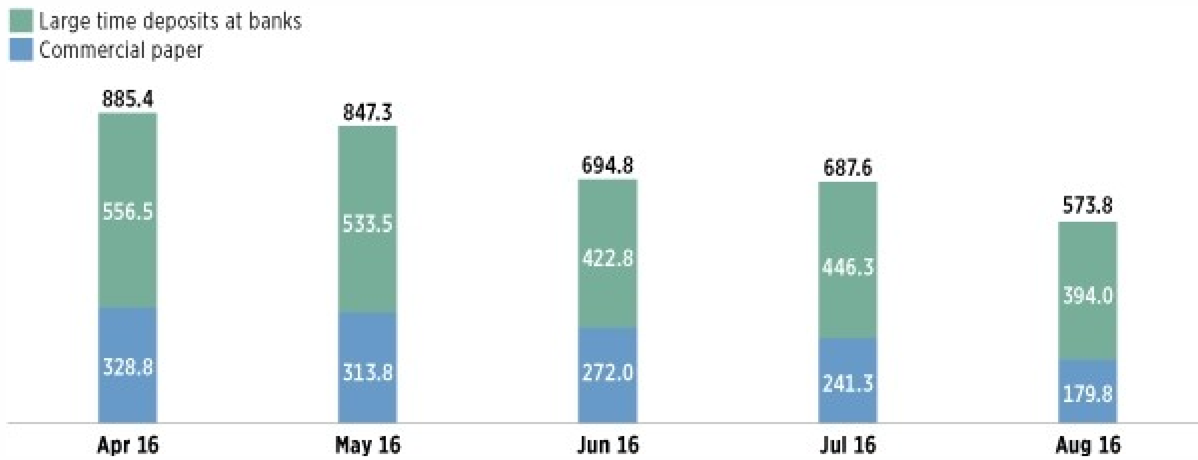
This *Viewpoints* discusses some of the effects of that shift in money market fund assets—combined with Federal Reserve policy and changes in banking rules—on the market for short-term borrowing and lending (i.e., the money market).

How Has This Shift Affected the Holdings of Prime Money Market Funds?

One effect is that with the steep drop in their assets, prime money market funds have had to reduce their holdings of money market instruments. For example, from April 2016 to August 2016, prime money market funds' holdings of large time deposits at banks (bank certificates of deposit and non-negotiable time deposits) declined $163 billion, while their holdings of commercial paper fell $149 billion (Figure 1).

FIGURE 1

Prime Money Market Fund Holdings of Commercial Paper and Large Time Deposits
Billions of dollars; month-end, April 2016–August 2016



Source: Investment Company Institute tabulations of SEC Form N-MFP data

What Has Happened to Money Market Interest Rates?

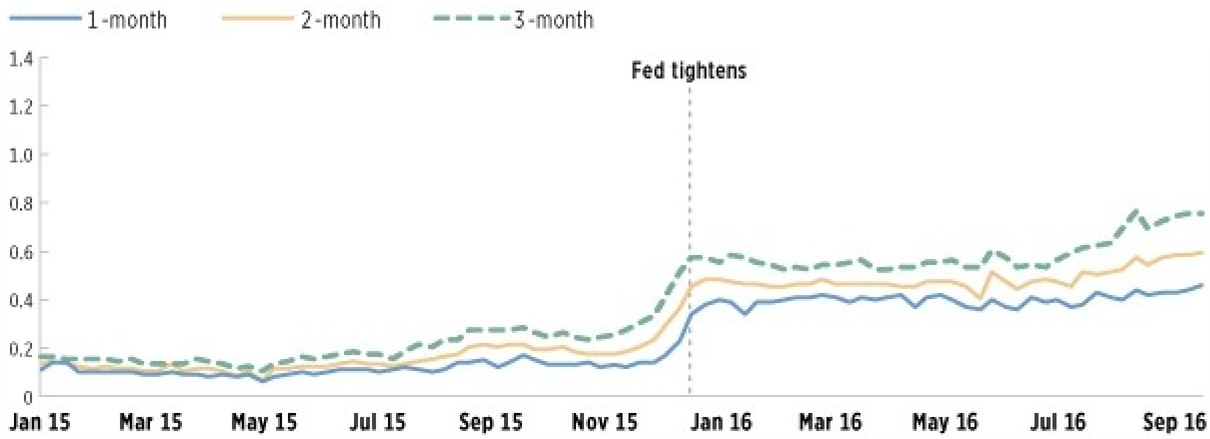
Since last October, interest rates on money market instruments have jumped. For example, Figure 2 shows that yields on three-month commercial paper have risen 0.51 percentage points (top panel), while rates on six-month Eurodollar deposits (an indicator of the interest rates banks will pay on large time deposits) rose more, 0.84 percentage points (bottom panel).

The increase is partly due to tighter monetary policy. The jump in rates last December reflected the Federal Reserve's decision to tighten monetary policy for the first time in several years. Since then, some of the increase in short-term interest rates also may reflect market participants' expectations that the Fed would tighten further in coming months.

FIGURE 2

Yield on Financial Commercial Paper

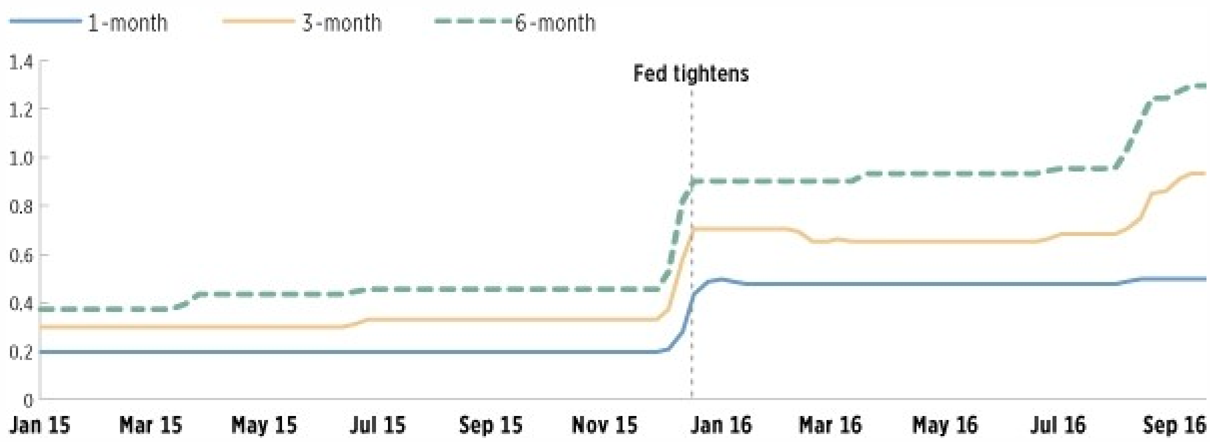
Percent per annum; weekly, January 2, 2015–September 16, 2016



Source: Federal Reserve Board

Eurodollar Deposit Interest Rates

Percent per annum; weekly, January 2, 2015–September 16, 2016



Source: Federal Reserve Board

Market participants note, however, that part of the rise in short-term interest rates probably reflects regulatory changes for both money market funds and banks:

- In advance of the October 14 deadline, prime funds have sought to lend dollars at the very short end of the yield curve, limiting their lending almost entirely to 30 days or less.
- Banks, in contrast, have been less willing to borrow at the very short end of the yield curve, because bank regulators have pushed them to limit their use of overnight or very short-term borrowing in funding their longer-term assets.

This mismatch—between prime money market funds seeking to lend short and banks seeking to borrow longer—may help explain why the yield on three-month commercial paper has risen more rapidly than the yield on one-month commercial paper since June 2016. Historically, much of the commercial paper that prime money market funds buy has been issued by banks.

Similarly, since the end of June 2016, six-month Eurodollar deposit rates increased relative to one-month rates by about 0.35 percentage points. The increase in the spread between one-month and six-month Eurodollar rates is consistent with the funding pressures between prime money market funds and banks.

Do These Developments Have Longer-Term Implications?

On the one hand, it seems likely that costs of borrowing at horizons of more than one month will continued to be elevated for some time. Market participants indicate that they expect to continue to see dollars leave prime and tax-exempt money market funds even after October 14. That's because retail investors, who *can* remain in stable $1.00 net asset value (NAV) prime and tax-exempt retail funds after October 14, may nevertheless adjust to the "new normal" by continuing to migrate to government money market funds, where they can avoid any potential for fees and gates. Also, regulations encouraging banks to "borrow long" aren't going away.

On the other hand, over time, these higher yields should prove attractive to other market participants, drawing them into the commercial paper market. Also, if over time investors learn more about how funds will operate under the new rule and realize that funds will only impose fees and gates under extreme conditions, they may reconsider prime funds. If so, prime funds might themselves be able to boost their holdings of commercial paper and buy longer maturities.

It is unclear to what extent these developments have affected banks. Banks have apparently been able to obtain other financing, through such devices as "advances" (loans) from Federal Home Loan Banks. US branches of foreign banks that had been borrowing dollars in the United States from prime money market funds may be able to obtain funding from their parent firms overseas. Consistent with this, according to Federal Reserve data, since the end of June commercial banks in the United States have expanded their loans to businesses and households by $75 billion.

Predictable Effects

So far, the effects of the new money market fund rules have been largely predictable:

- Institutional investors have reacted to the floating NAV and the prospect of fees and gates by reducing their holdings of prime money market funds.
- Retail investors and their intermediaries have reacted (perhaps more strongly than expected) to the prospect of fees and gates by reducing their holdings of prime and tax exempt money market funds.
- Government funds, which are exempt from the two main changes under the rules, have gained substantial new assets.
- Throughout all these shifts since January 2015, total money market fund assets have remained at a consistent level around $2.7 trillion.
- Money market interest rates have responded to the reforms and related flows, particularly as combined with the effects of bank regulatory changes and Federal Reserve policy.

- Extensive preparation by money market fund sponsors has helped funds, investors, and markets make a smooth transition.

ICI will continue to monitor developments in the money markets as the October 14 implementation date approaches, and beyond.

More Posts in This Series

- For Money Market Funds, Massive Preparation Has Paid Off in Smooth Transition
- As Money Market Fund Investors Adjust, Funds Have Managed Flows
- Money Market Fund Reforms Combine with Bank Regulations to Boost Interest Rates

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