Fed Expands Money Market Mutual Fund Liquidity Facility to Include Municipal Bonds

March 19, 2020

UPDATE AS Of MARCH 22: On March 20, 2020, the Federal Reserve ***announced*** *an expansion of the Money Market Mutual Fund Liquidity Facility (****MMLF****) originally announced on March 18, 2020. Under the expanded MMLF, certain municipal bonds are eligible as collateral and certain municipal money market funds are eligible for the support provided under the program. This updated memorandum reflects the terms of the program pursuant to the term sheet released by the Federal Reserve on March 20, 2020.*

The Federal Reserve's **creation** of a Money Market Mutual Fund Liquidity Facility (**MMLF**) follows the announcement of a **Commercial Paper Funding Facility** and a **Primary Dealer Credit Facility**, both of which we discussed earlier this week (**link** to CPFF memo, **link** to PDCF memo), and represents a continuation of the Federal Reserve's use of its "unusual and exigent" powers to help provide liquidity during the current crisis. The liquidity provided to money market mutual funds (**MMFs**) under the MMLF will be intermediated by the banking system.

Under an MMLF transaction, the Federal Reserve Bank of Boston would provide a non-recourse loan to a banking organization (as **eligible borrower**), taking as collateral certain types of assets (**eligible collateral**) purchased by the banking organization from an eligible MMF. To qualify for the facility, the eligible collateral must be purchased from an eligible MMF either (1) concurrently with the borrowing or (2) on or after March 18, 2020 but before the opening of the MMLF.

The MMLF, initially announced by the Federal Reserve on March 18, 2020 and expanded on March 20, 2020, is similar to the Asset-Backed Commercial Paper (**ABCP**) Money Market Fund Liquidity Facility (**AMLF**) established in September 2008, though the MMLF allows borrowers to pledge a broader range of eligible collateral than the AMLF, which was limited to only ABCP.

Key features of the MMLF, as of March 20, 2020, are described below. Additional information is available **here** through the Federal Reserve Bank of Boston, which includes **FAQs**, an **MMLF Request Form** and **borrowing documents** initially posted on March 21, 2020.[1]

- Several types of banking organizations are eligible to participate in the MMLF, similar to the AMLF.
  - **Eligible borrowers** under the MMLF include:
    - U.S. depository institutions;
    - U.S. bank holding companies (both parent companies incorporated in the United States and their U.S. broker-dealer subsidiaries); and
    - U.S. branches and agencies of foreign banks.

[1] The borrowing documents include the following: (i) **Letter Agreement to Correspondent Credit and Payment Agreement**, (ii) **Form of Agreement for Third-Party Custodian to Hold Collateral**; (iii) **Form FR 2046: Selected Balance Sheet Items for Discount Window Borrowers**, (iv) **Notice of Availability of Term Advances and Applicable Terms ("Terms")**, (v) **Certification – MMLF**, (vi) **Form of Authorizing Resolution for Borrowers**, and (vii) **Letter of Agreement – MMLF**.

  - Although savings and loan holding companies (**SLHCs**) were not expressly listed as eligible borrowers, it appears that they may also be eligible borrowers because they are covered by the associated regulatory capital relief (see below).
- The MMLF is designed to provide relief for, and liquidity to, prime MMFs, single state MMFs and other tax exempt MMFs (**eligible MMFs**).
  - After the SEC's **2014 reforms**, **prime MMFs** became a much smaller part of the MMF market. Unlike U.S. government MMFs, a prime MMF must have a floating net asset value (**NAV**) and redemption gates if the fund's weekly liquid assets fall below 30% of the fund's total assets.
  - Single state and other tax exempt MMFs (together, **municipal MMFs**) invest in securities exempt from local income taxes, primarily municipal bonds, and are also subject to the same floating NAV (in the case of institutional municipal MMFs) and redemption gate requirements (in the case of all municipal MMFs). Although these MMFs collectively represent only about a 3.5% share of the U.S. MMF market as of the end of February 2020, they are an important source of funding for local governments and municipal entities in the United States.[2]
  - **Government MMFs**, which invest most of their assets in cash, U.S. government securities and repurchase agreements backed by these securities, are now by far the largest portion of the MMF sector, holding 69.1% of net assets as of the end of February 2020.[3] Government MMFs are not eligible MMFs under the MMLF.
  - The need for the MMLF for prime and municipal MMFs calls into question the strength of the floating NAV requirements, redemption gates and other reforms for prime and municipal MMFs put into place in 2014.
- **Eligible collateral** under the MMLF is broader than under the AMLF. It includes:
  - U.S. Treasury and Fully Guaranteed Agency Securities;
  - Securities issued by U.S. Government Sponsored Entities (**GSEs**);
  - ABCP or unsecured commercial paper issued by a U.S. issuer rated at least A1, F1 or P1 by two or more major rating agencies (or rated within the top category if rated by only one major rating agency);
  - Potentially receivables from certain repurchase agreements; and
  - U.S. municipal debt with a maturity of 12 months or less rated in the short-term rating category at least SP1, MIG1, or F1 (as applicable) by two or more major rating agencies (or rated within the top category if rated by only one major rating agency). For municipal debt that is not rated in the short-term rating category, such debt still qualifies as eligible collateral if it is rated in the top long-term rating category (AA or above) by at least two major rating agencies (or rated within the top category if rated by only one major rating agency), provided that its remaining maturity is 12 months or less.
    - As of March 20, 2020, the MMLF will not accept variable rate demand notes (**VRDNs**) or tender option bonds. The Federal Reserve noted, however, that it would consider "the feasibility of adding these and other asset classes to the facility" in the future.

[2] Office of Financial Research, U.S. Money Market Fund Monitor, available at **https://www.financialresearch.gov/money-market-funds/us-mmfs-investments-by-fund-category/**.

[3] *Id.*

- Advances under the MMLF are non-recourse, and the size of each advance will equal the value of the collateral pledged to secure the advance[4] (100 percent loan-to-value), meaning that banking organization borrowers under the MMLF will bear no credit risk to the issuers of the eligible collateral.
- As with the Commercial Paper Funding Facility, the Department of the Treasury is providing $10bn of credit protection to the Federal Reserve Bank of Boston via the Exchange Stabilization Fund (**ESF**).
  - This credit protection is not a guaranty, for which Treasury could not currently use the ESF. This prohibition was imposed in the Emergency Economic Stabilization Act (**EESA**) of 2008, in response to Treasury's use of the ESF to backstop MMFs during the 2008 financial crisis.
  - The Senate Republican proposed Phase 3 coronavirus-related fiscal stimulus package, consistent with Treasury's proposal, temporarily would lift the EESA prohibition for the duration of the emergency. Duration of the emergency is defined under the Stafford Act. It would be up to Treasury to determine what the guaranty would entail (although the guaranty would be separate from the MMLF).
- The Federal Reserve, OCC and FDIC **issued** an interim final rule on March 19, 2020 amending the regulatory capital rules for depository institutions and depository institution holding companies. Its purpose was to neutralize the impact that banking organizations' participation in the MMLF, i.e. acquiring and holding eligible assets on their balance sheets, would otherwise have had.
  - Citing the non-recourse nature of the Federal Reserve's extensions of credit under the MMLF, the interim final rule allows banking organizations to exclude non-recourse exposures acquired as part of the MMLF from their total leverage exposure, average consolidated assets, and advanced approaches and standardized approaches risk-weighted assets, as applicable.
  - An institution's liability to the Federal Reserve under the MMLF must be reduced by the purchase price of the assets acquired with funds advanced by the Federal Reserve under the MMLF.
  - As noted above, the preamble and text of the Federal Reserve's portion of the interim final rule apply to all "Board-regulated institutions," which include SLHCs.
- Advances under the MMLF secured by U.S. Treasury and Fully Guaranteed Agency Securities, as well as securities issued by GSEs, will be provided at the primary credit rate. Advances secured by municipal bonds will be provided at the primary credit rate plus 25 bps. Advances secured by any other eligible collateral such as commercial paper will be provided at the primary credit rate plus 100 bps.
- **Procedural consideration**:
  - To access the facility, a borrower's CEO or other authorized person must certify, as required under for use of the Federal Reserve's "unusual and exigent circumstances" powers, that:
    - Both the borrower and the MMF from which it is purchasing collateral are not insolvent; and
    - The borrower is unable to secure adequate credit accommodations on the interbank market.
  - Prior to any extension of credit under the MMLF, a borrower must deliver a scanned copy of properly executed documents via e-mail to **MMLF@bos.frb.org**.
  - The program will open on March 23, 2020.
  - The MMLF will continue until September 30, 2020 unless extended by the Federal Reserve.

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[4] Collateral will be valued at either amortized cost or fair value.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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