Federal Reserve Amends Money Market Fund Liquidity Facility to Include Additional Collateral

On March 18, 2020, the Federal Reserve announced a Money Market Fund Liquidity Facility (MMLF) to make loans to banks and certain affiliates secured by certain assets acquired from “prime” money market funds (MMFs). The facility was originally intended to provide liquidity to “prime” MMFs by encouraging banks and their affiliates to acquire certain assets from such funds. On March 20, 2020, the Federal Reserve issued amendments to the program to add certain municipal securities to the list of “eligible collateral” and to add tax exempt MMFs under the MMLF. On March 23, 2020, the Federal Reserve issued further amendments to add negotiable certificates of deposit and all short-term municipal securities to the list of eligible collateral. This client alert updates and replaces our March 20, 2020, client alert “Federal Reserve Announces Money Market Fund Liquidity Facility.”

The facility reproduces the structure of the “Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility” (AMLF) established in 2008 when money market funds experienced a “run” because of their asset-back commercial paper (ABCP) holdings. Because the current threat to MMFs is the COVID-19 related general rush to liquidity, the new MMLF covers a broad range of collateral acquired from MMFs rather than just ABCP.

An important difference between the new MMLF and the AMLF is that loans secured by non-governmental collateral will bear interest at 1.0% above the primary credit rate. Loans secured by municipal short-term debt will bear interest at 0.25% above the primary credit rate, and loans secured by US government supported debt, as described below, will bear interest at the primary rate. The 1.0% spread for non-governmental debt collateral seems to raise questions about the feasibility of the facility to support much commercial paper held by MMFs that was issued before March 16.[1]

Similar to the 2008 AMLF program and in accordance with the Federal Reserve’s intent to encourage banks and their affiliates to provide liquidity to MMFs, on March 19 the federal banking regulatory agencies issued an interim final rule that excludes from capital computations assets acquired from MMFs supported by loans from the Boston Federal Reserve Bank under the new MMLF. This means such acquired assets will not be “assets” under either the risk-based or leverage capital computations made by banks and bank holding companies.

Money Market Liquidity Facility (MMLF) structure. As with the 2008 AMLF, the Federal Reserve Bank of Boston (Boston FRB) will make non-recourse loans to banks, bank holding companies, and their broker-dealer subsidiaries, including foreign bank branches and agencies, secured by “eligible collateral” acquired from eligible MMFs. Any MMF that identifies itself “as a Prime, Single State, or Other Tax Exempt money market fund under item A.10 of Securities and Exchange Commission Form N-MFP” will be eligible (i.e., for taxable funds, “prime” rather than “government security” money market funds).[5] Eligible collateral, as amended by the Federal Reserve on March 23, 2020, is:

1) U.S. Treasuries & Fully Guaranteed Agencies;

2) Securities issued by U.S. Government Sponsored Entities;

3) Asset-backed commercial paper, unsecured commercial paper, or a negotiable certificate of deposit that is issued by a U.S. issuer[1] and that has a short-term rating at the time purchased from the Fund or pledged to the Reserve Bank in the top rating category (e.g., not lower than A1, F1, or P1, as applicable) from at least two major nationally recognized statistical rating organizations (“NRSRO”) or, if rated by only one major NRSRO, is rated within the top rating category by that NRSRO;

4) U.S. municipal short-term debt (excluding variable rate demand notes) that:

   i. Has a maturity that does not exceed 12 months; and

   ii. At the time purchased from the Fund or pledged to the Reserve Bank:

1. Is rated in the top short-term rating category (e.g., rated SP1, MIG1, or F1, as applicable) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top rating category by that NRSRO; or

2. If not rated in a short-term rating category, is rated in one of the top two long-term rating categories (e.g., AA or equivalent or above) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top two rating categories by that NRSRO.

5) Variable rate demand note that:

i. Has a demand feature that allows holders to tender the note at their option within 12 months; and

ii. At the time purchased from the Fund or pledged to the Reserve Bank:

1. Is rated in the top short-term rating category (e.g., rated SP1, VMIG1, or F1, as applicable) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top rating category by that NRSRO; or

2. If not rated in a short-term rating category, is rated in one of the top two long-term rating categories (e.g., AA or equivalent or above) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top two rating categories by that NRSRO.

In addition, the facility may accept receivables from certain repurchase agreements. The feasibility of adding these and other asset classes to the facility will be considered in the future.

The March 23, 2020, amendments to the MMLF, therefore, added negotiable certificates of deposit (in item 3 above) and both tender option bonds (through item 4 above) and variable rate demand notes (through item 5 above) to the list of eligible collateral. The new item 3 consolidates ABCP and commercial paper, which previously were specified separately in items 3 and 4, into a single item along with negotiable certificates of deposit.

To encourage immediate bank participation, loans will be made against eligible collateral acquired on or after March 18, 2020, before the March 23, 2020,“opening” of the MMLF but, after that “opening,” only for eligible collateral acquired with the proceeds of the loan (i.e., after the program is established, banks will not be able to acquire assets from MMFs and later refinance those purchases with loans under the MMLF). Such eligible collateral acquired before March 23 must be pledged “expeditiously” starting March 23. Negotiable certificates of deposit and variable rate demand notes may serve as eligible collateral if acquired on or after March 23, 2020, and pledged on or after March 25, 2020.[2]

The Boston FRB loans will bear interest at a rate equal to 1.0% over the primary credit rate in effect for its “discount window,” except that loans secured by (1) “U.S. Treasuries & Fully Guaranteed Agencies or Securities issued by U.S. Government Sponsored Entities” will bear interest at the primary credit rate with no spread and (2) municipal short-term debt will bear interest at the primary rate plus 0.25%. The interest rate for AMLF loans was the primary credit rate with no spread. Similarly, the Primary Dealer Credit Facility established by the Federal Reserve on March 17 and described in our March 19, 2020, client alert “Federal Reserve Establishes Special Commercial Paper Backstop and Primary Dealer Funding Facilities,” provides for loans to bear interest at the primary credit rate.

To avoid market price discounts to commercial paper, ABCP, negotiable certificates of deposit, and short-term municipal debt covered as collateral under the program, such collateral will be valued at amortized cost. All other collateral will be valued at fair value (i.e., generally market price based) or amortized cost.

As with the AMLF, these loans from the Boston FRB will be non-recourse, so that the bank or affiliate’s holding of the “eligible collateral” will be “risk-free,” which is the basis for the final interim rule on capital computations described above.

Other terms of the MMLF are described in its term sheet issued by the Federal Reserve attached as Attachment I to this client alert. The interim final rule issued by the Federal banking agencies is available at this link:

https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200319a1.pdf

For More Information

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.

1 A U.S. issuer is an entity organized under the laws of the United States or a political subdivision or territory thereof, or is a U.S. branch of a foreign bank.

2 The March 23, 2020, updated MMLF states “The Facility will not accept negotiable certificates of deposit or variable rate demand notes until March 25, 2020. Negotiable certificates of deposit or variable rate demand notes purchased on March 23 or 24, 2020, must be pledged expeditiously starting on March 25, 2020.” Before the March 23 amendment, the MMLF explicitly excluded tender option bonds, along with variable rate demand notes, from the list of eligible collateral. That exclusion was removed by the March 23 amendment (expanding eligible collateral to include all “U.S. municipal short-term debt.”) The Federal Reserve’s March 23, 2020, press release, however, only explicitly mentions “municipal variable rate demand notes (VRDNs) and bank certificates of deposit” as added eligible collateral. Presumably, tender option bonds would be subject to the same pledge timing restrictions as VRDNs and CDs, since they also only became eligible collateral through the March 23 amendment.

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Money Market Mutual Fund Liquidity Facility

Facility: To provide liquidity to Money Market Mutual Funds ("Funds"), the Federal Reserve Bank of Boston ("Reserve Bank") will lend to eligible borrowers, taking as collateral certain types of assets purchased by the borrower from Funds.

Timing: The Facility will open on March 23, 2020. The Facility will generally take eligible collateral that:

1) If purchased after March 23, 2020, is pledged concurrently with the borrowing; or

2) If purchased on or after March 18, 2020, but on or before March 23, 2020, is pledged expeditiously starting on March 23, 2020.

For negotiable certificates of deposit and variable rate demand notes, a borrower may purchase these assets on or after March 23, 2020, and pledge them on or after March 25, 2020.[1]

Borrower Eligibility: All U.S. depository institutions, U.S. bank holding companies (parent companies incorporated in the United States or their U.S. broker-dealer subsidiaries), or U.S. branches and agencies of foreign banks are eligible to borrow under the Facility.

Funds: A Fund must identify itself as a Prime, Single State, or Other Tax Exempt money market fund under item A.10 of Securities and Exchange Commission Form N-MFP.

Advance Maturity: The maturity date of an advance will equal the maturity date of the eligible collateral pledged to secure the advance made under this Facility except in no case will the maturity date of an advance exceed 12 months.

Eligible Collateral: Collateral that is eligible for pledge under the Facility must be one of the following types:

1) U.S. Treasuries & Fully Guaranteed Agencies;

2) Securities issued by U.S. Government Sponsored Entities;

3) Asset-backed commercial paper, unsecured commercial paper, or a negotiable certificate of deposit that is issued by a U.S. issuer,[2] and that has a short-term rating at the time purchased from the Fund or pledged to the Reserve Bank in the top rating category (e.g., not lower than A1, F1, or P1, as applicable) from at least two major nationally recognized statistical rating organizations ("NRSRO") or, if rated by only one major NRSRO, is rated within the top rating category by that NRSRO;

4) U.S. municipal short-term debt (excluding variable rate demand notes) that:

    i. Has a maturity that does not exceed 12 months; and

    ii. At the time purchased from the Fund or pledged to the Reserve Bank:

        1. Is rated in the top short-term rating category (e.g., rated SP1, MIG1, or F1, as applicable) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top rating category by that NRSRO; or

        2. If not rated in a short-term rating category, is rated in one of the top two long-term rating categories (e.g., AA or equivalent or above) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top two rating categories by that NRSRO.

5) Variable rate demand note that:

    i. Has a demand feature that allows holders to tender the note at their option within 12 months; and

    ii. At the time purchased from the Fund or pledged to the Reserve Bank:

1. Is rated in the top short-term rating category (e.g., rated SP1, VMIG1, or F1, as applicable) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top rating category by that NRSRO; or

2. If not rated in a short-term rating category, is rated in one of the top two long-term rating categories (e.g., AA or equivalent or above) by at least two major NRSROs or if rated by only one major NRSRO, is rated within the top two rating categories by that NRSRO.

In addition, the facility may accept receivables from certain repurchase agreements. The feasibility of adding these and other asset classes to the facility will be considered in the future.

Rate: Advances made under the Facility that are secured by U.S. Treasuries & Fully Guaranteed Agencies or Securities issued by U.S. Government Sponsored Entities will be made at a rate equal to the primary credit rate in effect at the Reserve Bank that is offered to depository institutions at the time the advance is made.

Advances made under the Facility that are secured by U.S. municipal short-term debt, including variable rate demand notes, will be made at a rate equal to the primary credit rate in effect at the Reserve Bank that is offered to depository institutions at the time the advance is made *plus* 25 bps.

All other advances will be made at a rate equal to the primary credit rate in effect at the Reserve Bank that is offered to depository institutions at the time the advance is made *plus* 100 bps.

Fees: There are no special fees associated with the Facility.

Collateral Valuation: The collateral valuation will either be amortized cost or fair value. For asset-backed commercial paper, unsecured commercial paper, negotiable certificates of deposit, and U.S. municipal short-term debt, including variable rate demand notes, the valuation will be amortized cost.

Advance Size: Each advance shall be in a principal amount equal to the value of the collateral pledged to secure the advance.

Credit Protection by the Department of the Treasury: The Department of the Treasury, using the Exchange Stabilization Fund, will provide $10 billion as credit protection to the Reserve Bank.

Non-Recourse: Advances made under the Facility are made without recourse to the Borrower, provided the requirements of the Facility are met.

Regulatory Capital Treatment: On March 19, 2020, the Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation issued an interim final rule to allow banking organizations to neutralize the effects of purchasing assets through the program on risk-based and leveraged capital ratios. See https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200319a1.pdf.

Program Termination: No new credit extensions will be made after September 30, 2020, unless the Facility is extended by the Board of Governors of the Federal Reserve System.

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1 The Facility will not accept negotiable certificates of deposit or variable rate demand notes until March 25, 2020. Negotiable certificates of deposit or variable rate demand notes purchased on March 23 or 24, 2020, must be pledged expeditiously starting on March 25, 2020.

2 A U.S. issuer is an entity organized under the laws of the United States or a political subdivision or territory thereof, or is a U.S. branch of a foreign bank.