Chapman and Cutler LLP

Chapman Client Alert

March 20, 2020 Current Issues Relevant to Our Clients

Federal Reserve Announces Money Market Fund Liquidity Facility

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. Earlier today (March 20), 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.

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[2] 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.[3] 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.[4]

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 earlier today, is:

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

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

3) Asset-backed commercial paper that is issued by a U.S. issuer, is rated at the time purchased from the Fund or pledged to the Reserve Bank not lower than A1, F1, or P1 by at least two major rating agencies or, if rated by only one major rating agency, is rated within the top rating category by that agency;

4) Unsecured commercial paper that is issued by a U.S. issuer, is rated at the time purchased from the Fund or pledged to the Reserve Bank not lower than A1, F1, or P1 by at least two major rating agencies or, if rated by only one major rating agency, is rated within the top rating category by that agency; or

5) U.S. municipal short-term debt 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. If rated in the short-term rating category, is rated in the top short-term rating category (e.g., rated SP1, MIG1, or F1, as applicable) by at least two major rating agencies or if rated by only one major rating agency, is rated within the top rating category by that agency; or 2. If not rated in the short-term rating category, is rated in the top long-term rating category (e.g., AA or above) by at least two major rating agencies or if rated by only one major rating

agency, is rated within the top rating category by that agency.

In addition, the facility may accept receivables from certain repurchase agreements. The facility at this time will not take variable rate demand notes or tender option bonds, but the feasibility of adding these and other asset classes to the facility will be considered in the future.

To encourage immediate bank participation, loans will be made against eligible collateral acquired on or after March 18, 2020, before the "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).

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 Commercial Paper Funding 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 and ABCP 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.

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1 At 1% above the primary credit rate, loans to finance purchases of private commercial paper will currently bear interest at 1.25%. The Federal Reserve's latest H.15 release https://www.federalreserve.gov/releases/h15/ shows commercial paper issued on March 12 and 13 bearing effective interest rates below 1.25%. In general, following the FOMC's March 3, 2020, 50 bps reduction in the target federal funds rate commercial paper rates were below 1.25%. As shown on the linked H.15, commercial paper rates spiked above 1.25% on March 16, despite the FOMC's March 15 reduction in the target rate. It is unclear why a bank would use a 1.25% interest rate loan from the Boston FRB to purchase commercial paper earning an effective interest rate below 1.25%.

2 In 2008 the federal agencies provided a 0% risk weight for ABCP acquired under the AMLF.

3 The Federal Reserve's exclusion (which is repeated by the FDIC and OCC in the jointly announced interim final rule) is:

Notwithstanding any other section of this part, a board-regulated institution may exclude exposures acquired pursuant to a non-recourse loan that is provided as part of the Money Market Mutual Fund Liquidity Facility, announced by the Board on March 18, 2020, from total leverage exposure, average total consolidated assets, advanced approaches total risk-weighted assets, and standardized total risk-weighted assets, as applicable, For the purpose of this provision, a board-regulated institution's liability under the facility must be reduced by the purchase price of the assets acquired with funds advanced from the facility.

4 Banks have long complained that balances held at Federal Reserve Banks are generally included as assets requiring capital support under the leverage ratio requirement. The interim rule creates the anomaly that an asset supported by a non-recourse loan from the Boston Federal Reserve Bank will not be an asset for the leverage ratio computations, but deposit balances at that Reserve Bank will generally be assets for that computation.

5 Government securities money market funds have special rules that permit them to maintain a “stable” $1 value, whereas prime funds are required to have certain rights to no maintain a stable $1 NAV and to limit redemptions if that $1 value may not be maintained.

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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") would lend to eligible borrowers, taking as collateral certain types of assets purchased by the borrower from Funds (i) concurrently with the borrowing; or (ii) on or after March 18, 2020, but before the opening of the Facility.

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 that is issued by a U.S. issuer, is rated at the time purchased from the Fund or pledged to the Reserve Bank not lower than A1, F1, or P1 by at least two major rating agencies or, if rated by only one major rating agency, is rated within the top rating category by that agency;

4) Unsecured commercial paper that is issued by a U.S. issuer, is rated at the time purchased from the Fund or pledged to the Reserve Bank not lower than A1, F1, or P1 by at least two major rating agencies or, if rated by only one major rating agency, is rated within the top rating category by that agency; or

5) U.S. municipal short-term debt that:

   i. Has a maturity that does not exceed 12 months; <u>and</u>

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

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

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

In addition, the facility may accept receivables from certain repurchase agreements. The facility at this time will not take variable rate demand notes or tender option bonds, but 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 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 and U.S. municipal short-term debt, 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.

Investment by Department of Treasury: The Department of Treasury, using the Exchange Stabilization Fund, would 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.