October 30, 2008

MMMF, and AMLF, and MMIFF. Part 2 of a 2-part Series

On Tuesday we left off with a promise to do a post focusing on the Fed's **A**sset-Backed Commercial Paper **M**oney Market Mutual Fund **L**iquidity **F**acility (AMLF) and Money Money Market Investor Funding Facility (MMIFF). We're making good on that promise. Whereas the Commercial Paper Funding Facility (CPFF) was targeted primarily at issuers of commercial paper and intended to improve market conditions for businesses that rely on the CP market to finance themselves, both the AMLF and MMIFF are targeted at money market funds (MMFs) and helping them meet escalating redemption requests.

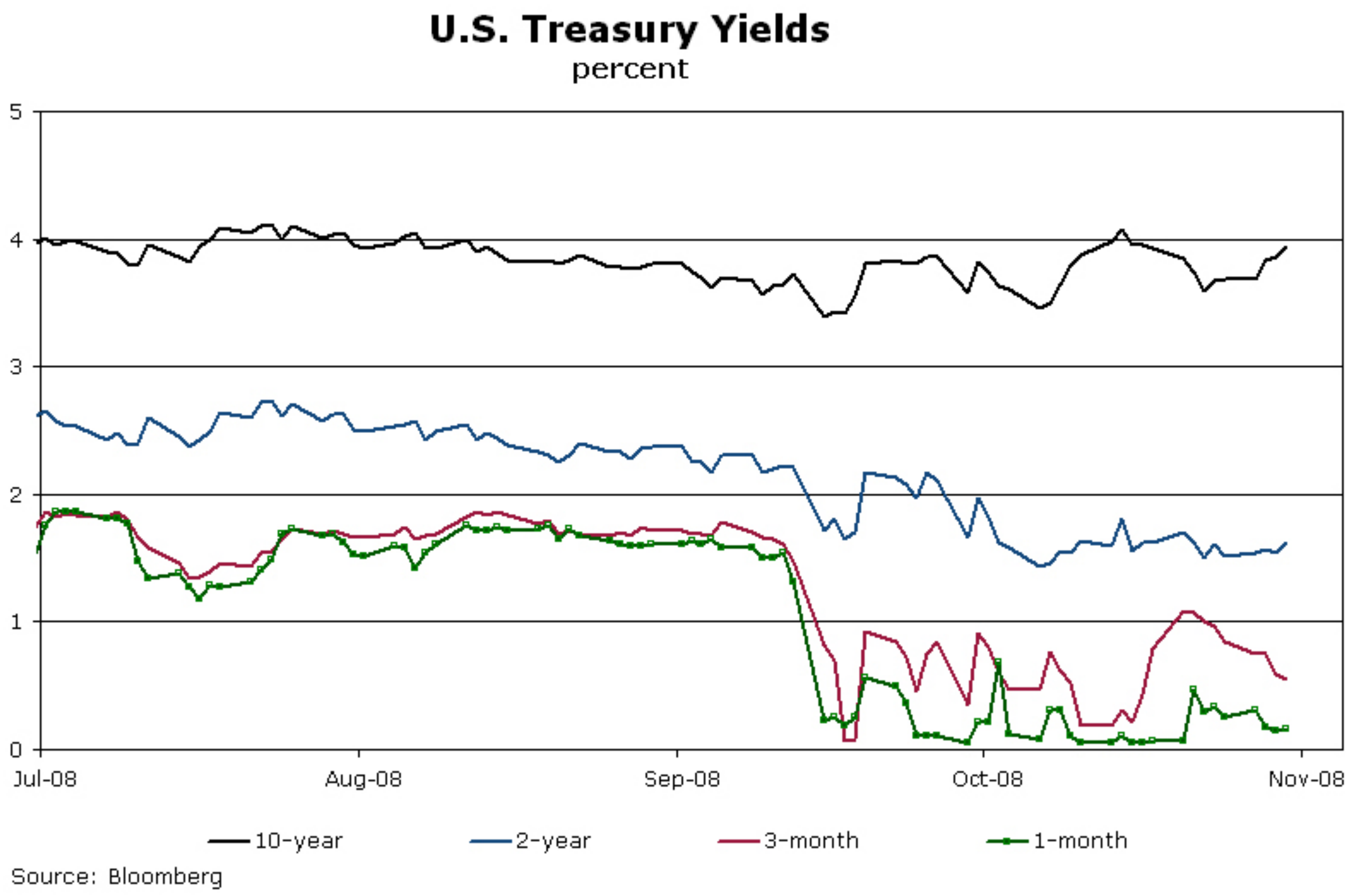
A Bloomberg article by Christopher Condon and Bryan Keogh does a nice job of describing the circumstances immediately preceding the creation of the AMLF:

> "**While money funds were selling commercial paper in the past few months, the exodus accelerated after the bankruptcy of Lehman Brothers Holdings** Inc. on Sept. 15 and the breakdown of the nation's oldest money-market fund the next day."
>
> "The $62.5 billion Reserve Primary Fund announced Sept. 16 that losses on debt issued by Lehman had reduced its net assets to 97 cents a share, making it the first money fund in 14 years to break the buck, the term for falling below the $1 a share that investors pay. **Over the next two days, investors pulled $133 billion from U.S. money-market funds**, according to IMoneyNet." (emphasis added)

As has been publicized, the large withdrawals from money market funds were not without consequence. MMFs provide a link between investors looking to earn a return on their money and businesses looking to sell their short-term debt. A break in the link can lead to reduced business activity and pose risks to economic growth.

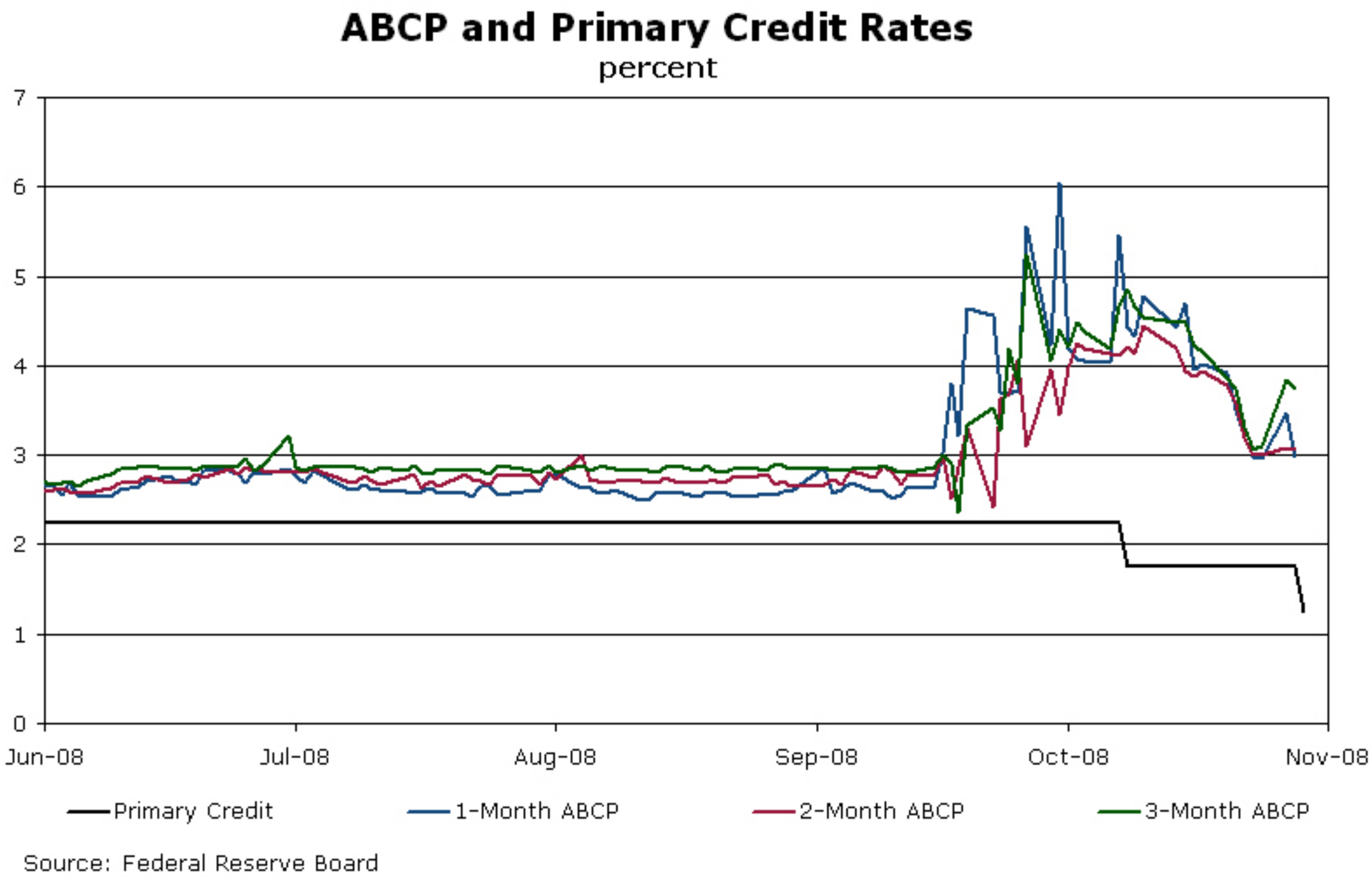
Conditions in the commercial paper market had already been under stress prior to the Reserve Primary Fund's losses. Weak demand for CP and the massive outflows from MMFs forced some funds to sell the paper in an illiquid market—leading in some cases to losses, something that isn't supposed to happen in MMFs.

Compounding the issues in the CP market was a reallocation of MMFs' portfolios toward safer Treasury securities. In addition to the desire of MMFs to shed CP and other assets to meet redemptions, MMFs have been reallocating their assets toward safer, more liquid, Treasuries. MMFs were not alone. The general flight to safety among investors is immediately recognizable in the large drop in Treasury yields (particularly on shorter-dated securities) since Sept 15.

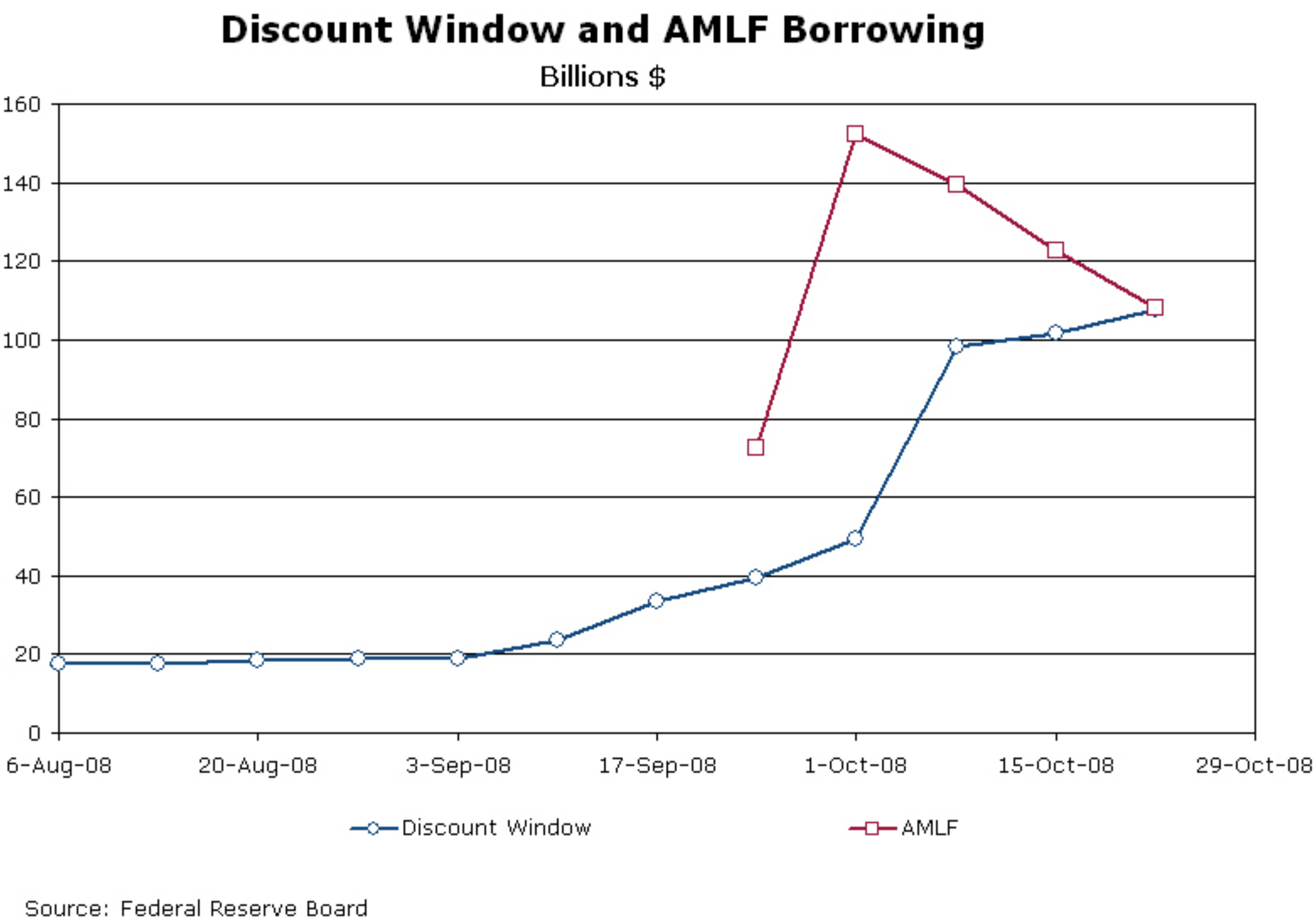


The MMF outflows slowed after the Treasury announced on Sept 19 they would temporarily guarantee money market funds (on amounts held at the close on Sept 19), and after the Fed announced the AMLF on the same day.

The AMLF provides nonrecourse loans at the primary credit rate to U.S. depository institutions, bank holding companies, or U.S. branches and agencies of foreign banks. They can then use the loans to purchase eligible A-1/P-1/F-1 ABCP at amortized cost from MMFs. A bank that borrows under the program is at no risk for loss as credit risk is effectively transferred to the Fed. The chart below shows rates on 1, 2, and 3-month ABCP and the primary credit rate and can give an idea of what kind of spread a bank can earn through arbitrage (borrowing at the discount window and purchasing ABCP). So, if a MMF experiences redemptions, it can sell its ABCP to a bank without taking a loss and a bank can make a profit by earning the spread between the discount window rate and the rate on purchased ABCP. A secondary effect is that by reducing risk associated with lack of liquidity in the secondary market for CP, the AMLF provides an incentive for MMFs to resume their purchases of ABCP from issuers.



AMLF borrowing from the Fed to finance ABCP purchases from MMF has grown markedly from $73 billion on Sept 24 to $108 billion on Oct 22. To compare, discount window lending, which has reached record levels, rose from $39 billion to $108 billion over the same period.



To complement the AMLF, the Fed announced on Oct 21 the creation of the MMIFF which will provide funding up to $540 billion in financing to purchase U.S. dollar-denominated certificates of deposit (CDs), bank notes, and CP. Similar to the AMLF, the MMIFFF will support MMFs in meeting redemptions by purchasing assets which might otherwise need to be sold in an illiquid market. It differs from the AMLF primarily because it's targeted at purchasing a broader set of assets, including unsecured CP. The MMIFF differs from the CPFF in that it aims to help money market funds rather than issuers of CP.

While the MMIFF start date is still being determined, the NY Fed provides a series of helpful FAQs explaining how the program will work.

Recovery in MMF and CP markets may be a significant factor in restoring normalcy to credit markets and should have broader, positive impacts. The Federal Reserve Board states: "Improved money market conditions will enhance the ability of banks and other financial intermediaries to accommodate the credit needs of businesses and households."

Today's Fed release showing the first increase in CP outstanding since mid-Sept is a good sign.

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October 30, 2008 in Capital Markets | Permalink