S. 1117 / H.R. 2319

The Importance of Restoring State and Local Government Access to Money Market Funds

New MMF regulations that were implemented in October 2016 are having major negative consequences for issuers and borrowers of debt held by money market funds. Specifically, Tax-Exempt MMFs (TE MMFs) are closing and assets are leaving. This is drying up a very important municipal financing conduit. Additionally, the flight of assets out of Prime MMFs is resulting in higher borrowing costs for municipalities as the pool of available capital decreases.

As TE MMFs close, municipalities have fewer buyers for their debt. Even when they are able to borrow from the remaining TE funds, they are less able to lock in rates and more subject to weekly rate resets. As we are seeing clearly in the current market today, this increases volatility and adds to their borrowing costs. If they are not able to place their debt issues with TE MMFs, only two options are available. They must turn to other lenders that have higher transaction costs / charge higher rates, or they must defer / cancel planned infrastructure, educational, healthcare and other municipal projects.

This paper will demonstrate the negative impacts on municipal financing of new MMF regulation:

- Massive amounts of assets are leaving Tax-Exempt MMFs;
- Borrowing rates for municipal borrowers have increased dramatically;

Between January 2016 and April 2018, over $110 billion left TE MMFs, a decline of more than 40%. Since TE MMFs provide significant financing to municipal borrowers, the short-term market for municipal debt is significantly smaller. The SIFMA Municipal Borrowing Index was just 1 basis point in January 2016. Now it swings wildly in a range of 100 – 180 bps. Such volatility renders this source of municipal funding much less attractive. Furthermore, the rate increase is more than double the Fed rate increase over the same period. Fed Funds rose from 50 to 175 bps - an after-tax increase equal to 75 bps.[1]

Without Tax-Exempt MMFs, municipalities are forced to use higher-cost financing sources like bank credit, or reduce their short-term capital consumption. Projects in infrastructure, healthcare, education and government services will be impacted.

TE MMF assets have declined by more than 40% since implementation of new regulations and remain near those historic low levels eighteen months later. This was not an inconsequential "temporary decline".

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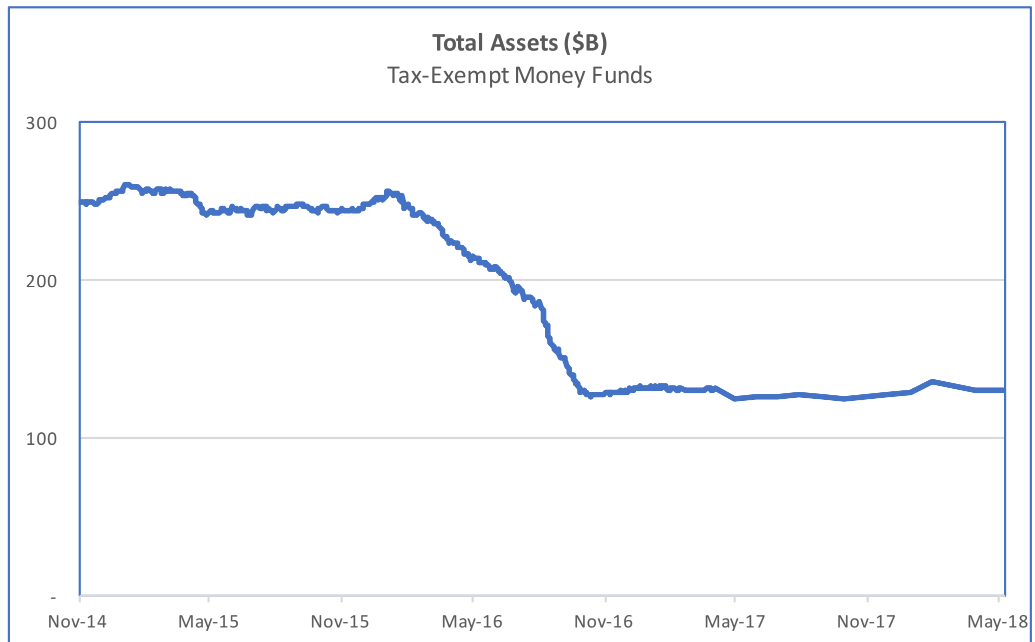
[1] A 125 bp increase at an assumed 40% tax rate. 60% of 125 bps = 75 bps. Some commentators mistakenly claim that municipal borrowing costs rose in lockstep with the Fed rate increase. That ignores the tax differential which is the key driver of the municipal market.

MMFs have historically been an important holder of short-term municipal debt. As of January 2016, they provided over $250 billion of short-term funding to municipalities by purchasing their short-term debt instruments. By April 2018, TE MMFs were at barely half that level, and were one-quarter of pre-crisis June 2008 levels.

Figure 1 shows the precipitous 2016 decline in TE MMF assets prior to the implementation of new regulations in October. Note that **TE MMF assets in April 2018 stand at $138 billion, hovering near their historic low.**

Figure 1.Tax-Exempt Money Fund Asset Levels ($B),
Source: CraneData.com, Treasury Strategies (May 2018)



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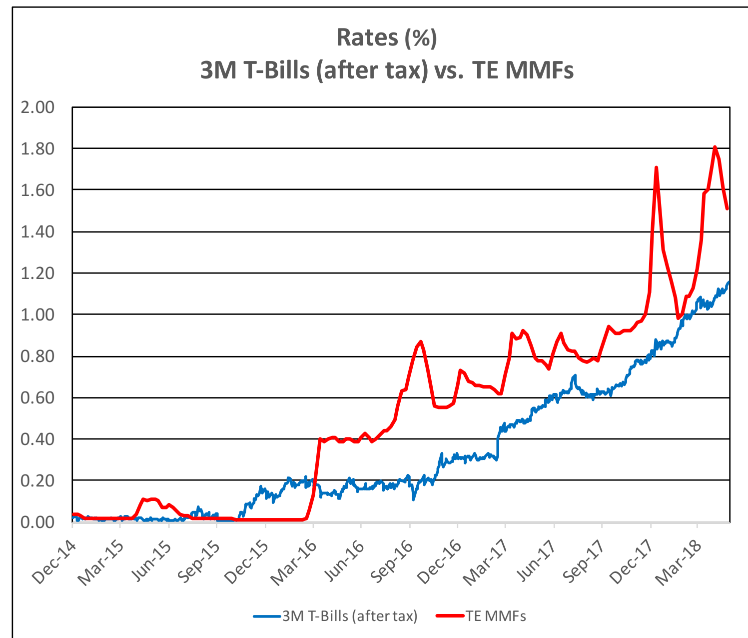
Municipal Borrowing Cost Benchmarks Have Increased Dramatically

As TE MMFs assets have fallen and numerous TE funds have closed, municipal borrowers are paying increasingly high rates to secure financing. Figure 3 shows that the TE MMF yields, a proxy for municipal borrowing costs have jumped from just 1 basis point at the beginning of 2016, to a volatile 100-180 bps range. This greatly increases borrowing costs and uncertainty for municipalities, university and hospitals. Since most debt resets weekly, borrowing costs on existing debt has increased over ten times for many borrowers.

In January, 2016, the median rate paid by municipal borrowers was 5 bps. By April, 2018, that jumped to 178 bps.

Figure 3. Comparison TE MMF yields (%) vs. 3M T-Bills (after tax), Source: Cranedata, Treasury Strategies (May 2018)



Before the new MMF regulations went into effect, municipal short term borrowing rates were consistently lower than the after-tax Fed Funds and T-Bill rates. Since then, however, municipal rates have been well above the after-tax Fed Funds rate.

Municipalities fortunate enough to continue selling VRNDs to Tax Exempt MMFs saw borrowing costs skyrocket at more than double the Fed rate increase – 170 bps vs. 75 bps after tax. Other municipalities would have to borrow from different investors, or replace their VRDNs with bank loans at much higher rates and longer maturities.

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Municipal BORROWING from TEMMFs has DECREASED Dramatically

Municipalities in 48 of 50 states have lost funding from MMFs between January, 2016 and April, 2018.[2] For 21 states, the toll has been in excess of $1 billion each. Those municipalities that lost funding must now resort to higher cost bank debt, more costly long-term debt or forego projects entirely.

The following table shows the impact on a select sample of states.

Figure 4. Loss of Funding to Tax-Exempt Money Fund issuers from Select States
Source: Cranedata.com, Treasury Strategies (April 2018)

State	Principal 1/1/16 ($000,000)	Principal 4/30/18 ($000,000)	Change in Funding ($000,000)	Change in Funding %
Alabama	2,454	1,947	(507)	-21%
Arkansas	1,496	985	(511)	-34%
California	33,925	17,422	(16,503)	-49%
Colorado	4,238	2,693	(1,545)	-36%
Georgia	3,855	3,021	(835)	-22%
Hawaii	278	321	43	16%
Idaho	631	404	(227)	-36%
Indiana	4,459	1,765	(2,694)	-60%
Kansas	726	428	(298)	-41%
Louisiana	2,674	1,944	(729)	-27%
Maryland	2,800	1,413	(1,387)	-50%
Massachusetts	9,615	5,209	(4,406)	-46%
Montana	153	166	13	8%
Nebraska	932	775	(157)	-17%
Nevada	2,665	1,802	(862)	-32%
New Jersey	7,468	4,759	(2,709)	-36%
New York	38,560	22,133	(16,427)	-43%
North Carolina	4,183	1,370	(2,813)	-67%
North Dakota	544	140	(404)	-74%
Ohio	4,607	2,244	(2,363)	-51%
Pennsylvania	6,418	4,422	(1,996)	-31%
Rhode Island	498	171	(328)	-66%
South Carolina	1,927	505	(1,422)	-74%
South Dakota	351	77	(274)	-78%
Tennessee	3,119	2,284	(835)	-27%
Virginia	2,705	1,548	(1,156)	-43%
Total - All States	238,706	138,299	(100,407)	-42%

[2] Montana and Hawaii are the only two states to see an increase in funds from money market funds. Their gains were $12M and $43M respectively.

Municipal Borrowing RATES from TEMMFs have INCREASED Dramatically

Municipalities in ALL states that have been fortunate enough to continue borrowing from TEMMFs have seen funding costs increase by 1.5% to 1.9%. On a tax equivalent basis, adjusting for the fact that these securities are tax exempt, the effective rate increase ranges from 2.4% to 3.2%. During this same period, the Federal Reserve raised interest rates only 1.25%.

The following table shows the impact on a representative sample of states.

Figure 5. Change in borrowing costs to Tax-Exempt Money Fund issuers from Select States Source: Cranedata.com, Treasury Strategies (April 2018)

State	Median 1/1/16	Median 4/30/18	Rate Increase %	Tax Equivalent Rate Increase %
Alabama	0.05%	1.77%	1.72%	2.87%
Arkansas	0.02%	1.72%	1.70%	2.83%
California	0.03%	1.76%	1.73%	2.88%
Colorado	0.03%	1.80%	1.77%	2.95%
Georgia	0.07%	1.78%	1.71%	2.85%
Hawaii	0.25%	1.78%	1.53%	2.55%
Idaho	0.03%	1.83%	1.80%	3.00%
Indiana	0.04%	1.80%	1.76%	2.93%
Kansas	0.03%	1.82%	1.79%	2.98%
Louisiana	0.03%	1.80%	1.77%	2.95%
Maryland	0.06%	1.79%	1.73%	2.88%
Massachusetts	0.05%	1.78%	1.73%	2.88%
Montana	0.03%	1.78%	1.75%	2.92%
Nebraska	0.04%	1.73%	1.69%	2.82%
Nevada	0.02%	1.78%	1.76%	2.93%
New Jersey	0.10%	2.00%	1.90%	3.17%
New York	0.30%	1.78%	1.48%	2.47%
North Carolina	0.02%	1.78%	1.76%	2.93%
North Dakota	0.05%	1.78%	1.73%	2.88%
Ohio	0.10%	1.79%	1.69%	2.82%
Pennsylvania	0.03%	1.78%	1.75%	2.92%
Rhode Island	0.02%	1.77%	1.75%	2.92%
South Carolina	0.25%	1.80%	1.55%	2.58%
South Dakota	0.03%	1.87%	1.84%	3.07%
Tennessee	0.05%	1.77%	1.72%	2.87%
Virginia	0.04%	1.77%	1.73%	2.88%
Total - All States	0.05%	1.78%	1.73%	**2.88%**
Fed Funds Rate	0.50%	1.75%	1.25%	**1.25%**

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Conclusion

New SEC rules that change how MMFs function are having many unintended consequences. One such consequence now manifesting itself is a material reduction in the short-term credit available to municipal borrowers whose debt is held by Tax-Exempt MMFs. As recently as January 2016, Tax-Exempt MMF assets exceeded $250 B. As of August 2018, they are now at $138 B, a loss of over $110 B.

These changes have also lead to a dramatic increase in municipal borrowing costs. Many municipalities have seen borrowing rates increase substantially since 2016, from a median of 5 bps to 178 bps today.

With seriously shrinking Tax-Exempt MMFs, municipalities are being forced to seek higher cost borrowing options like bank credit. Their only other alternative is to scrap projects and reduce their short-term capital consumption. Neither option bodes well for the U.S. economy and tax payer.

Some major market participants and trade associations are downplaying this significant problem by suggesting "further study". In fact, this has now been playing out in the market for nearly two full years. That's the real study. Even after two years, rising rates and a strong economy, funds have not returned, suggesting that the impact of the SEC regulations are permanent and fatal.

S. 1117 and H.R. 2319 restore Tax Exempt and Prime Money Market Funds and will facilitate the flow of capital back these important segments of the economy.

About Treasury Strategies

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