

Money Market Commentary: Regulatory Reform and Monetary Policy Remain at the Forefront

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Key Takeaways

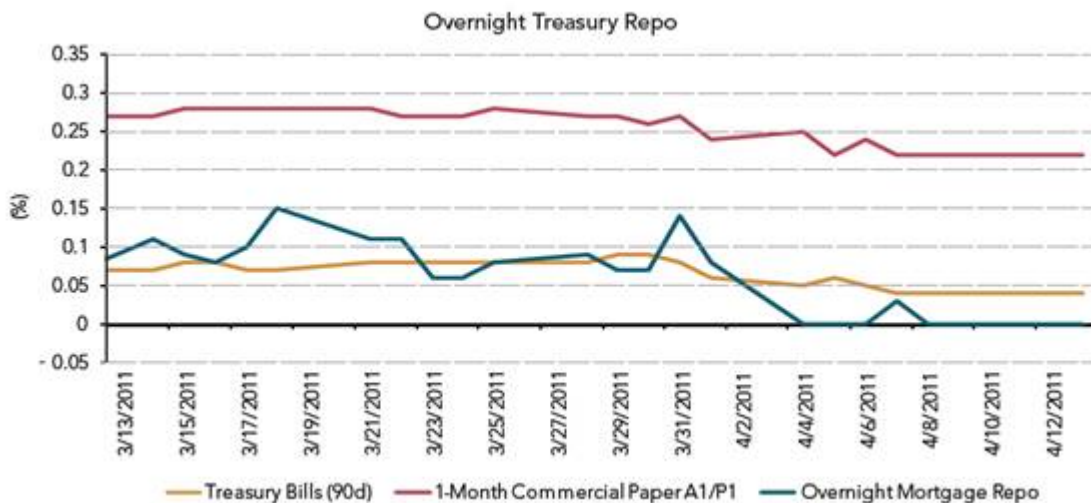
- The newly expanded FDIC assessment disrupted markets by reducing bank arbitrage trades, lowering repo rates in the process
- Moody's revised its money market fund rating methodology to provide greater differentiation and transparency
- Despite increasing signs of a sustained economic recovery, the Federal Open Market Committee stated intentions to continue purchasing Treasury securities through its second round of quantitative easing

Changes to FDIC assessment lowers rates across the front-end of the curve

On April 1st, the FDIC implemented its new methodology of charging banks for deposit insurance. The new assessment base was expanded to include consolidated bank assets less tier 1 capital compared to the old assessment which only accounted for domestic deposits. The total fee charged to banks is expected to range from 2.5 to 45 basis points while the average fee may be closer to 10-15 basis points. The additional fees banks are now required to pay on financing has either reduced or eliminated the economic incentive to borrow funding through the repo market. In the first few weeks following the implementation of the new assessment, Treasury repo rates declined to less than 0.05%.¹ As a result, short-term rates declined across all sectors, including Treasury bills and commercial paper which can be seen below.

Moody's revises its money market fund rating methodology

Moody's released a new rating methodology including new rating symbols and definitions that gauge a fund's ability to meet the dual objectives of providing liquidity and preserving capital. Moody's goal is to differentiate money market funds based on each fund's intrinsic risk profile and its likely response to market stresses. While the new ratings have been designed to provide greater differentiation and transparency, recent changes to Rule 2a-7 have already greatly enhanced the liquidity and risk provisions of all funds across the industry. In addition, the implementation of BASEL III will also enhance the safety of - 0.05 money market funds by increasing the resilience of financial issuers' debt that is held by money market funds. Additional risk mitigating ideas will be considered by SEC and the Financial Stability Oversight Council (FSOC) at a roundtable on May 10. The roundtable will cover the options laid forth by the President's Working Group report that was issued in October 2010.



Spring is in the air

While the signs of economic recovery continue to flourish, high unemployment, stable long-term inflation expectations and the tragedy in Japan have encouraged policymakers to maintain monetary stimulus. The Federal Open Market Committee (FOMC) unanimously agreed to continue expanding its holding of securities through its second round of

quantitative easing (QE2). The Federal Reserve is expected to complete the purchase of \$600 billion of long-term Treasury securities by the end of the second quarter while the prospects for a third round of large scale asset purchases appears unlikely. While the Fed is committed to employ its policy tools to support the economic recovery and keep inflation consistent with its mandate, Federal Reserve Presidents (Charles Plosser of Philadelphia and Richard Fisher of Dallas) expressed concerns over the last few weeks that the central bank should consider removing monetary stimulus before year end. Although inflation expectations have trended higher and unemployment has declined, the slack in the employment market leads economists to believe that the Fed will continue to assess conditions before shifting its accommodative approach to monetary policy.

The Fed's transition of monetary policy will not be as straightforward through this cycle. The Fed's elevated balance sheet could create operational challenges that would extend the transition process. After the Fed stops purchasing assets, it will likely modify its "extended period" language and communicate its intentions. The Fed will likely drain reserves through several methods, including reverse repurchase agreements with money market funds, term deposits, reinstating the supplemental financing bill programs (SFB), and passive roll-offs of interest and prepayments from the \$2 trillion portfolio of mortgage and treasury securities on its balance sheet. These actions would help remove excess liquidity in the market to help restore the fed funds effective rate as a policy tool which the Fed will eventually use to raise interest rates.

1. Bloomberg as of 4/8/11

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Interest rate increases can cause the price of money market securities to decrease.

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