Discussing "The Impact of the Shadow Banking Sector on Public Finance" for the Brookings Muni Finance Conference

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Considerations for users of the study

- ICI flow data are clear that 2a7 assets declined post SEC reform
- But effectively analyzing municipal issuers' short-term capital market costs is extremely difficult as most of those costs are non-public
- And most governments used floating rate debt to access synthetic fixed rates via derivatives; floating rates were not typically a focus
- In a post-derivatives market, and as bank capital regulations changed, state and local governments' reliance on money market funds dissipated
- Governments now use bank loans, the costs of which are also non-public
- Municipal data (always) has gaps and limitations that carry through to analyses that lean heavily on data alone

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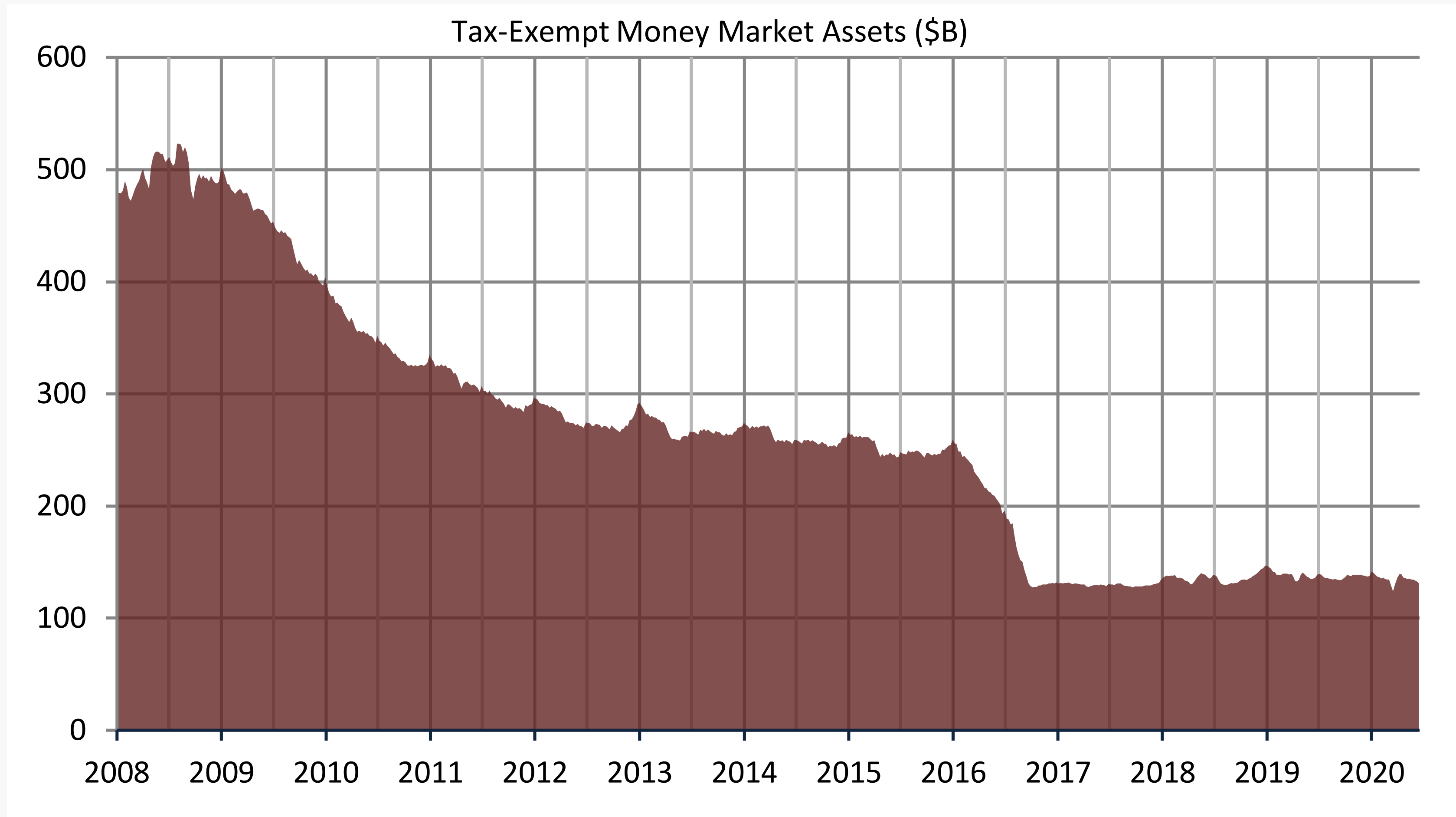
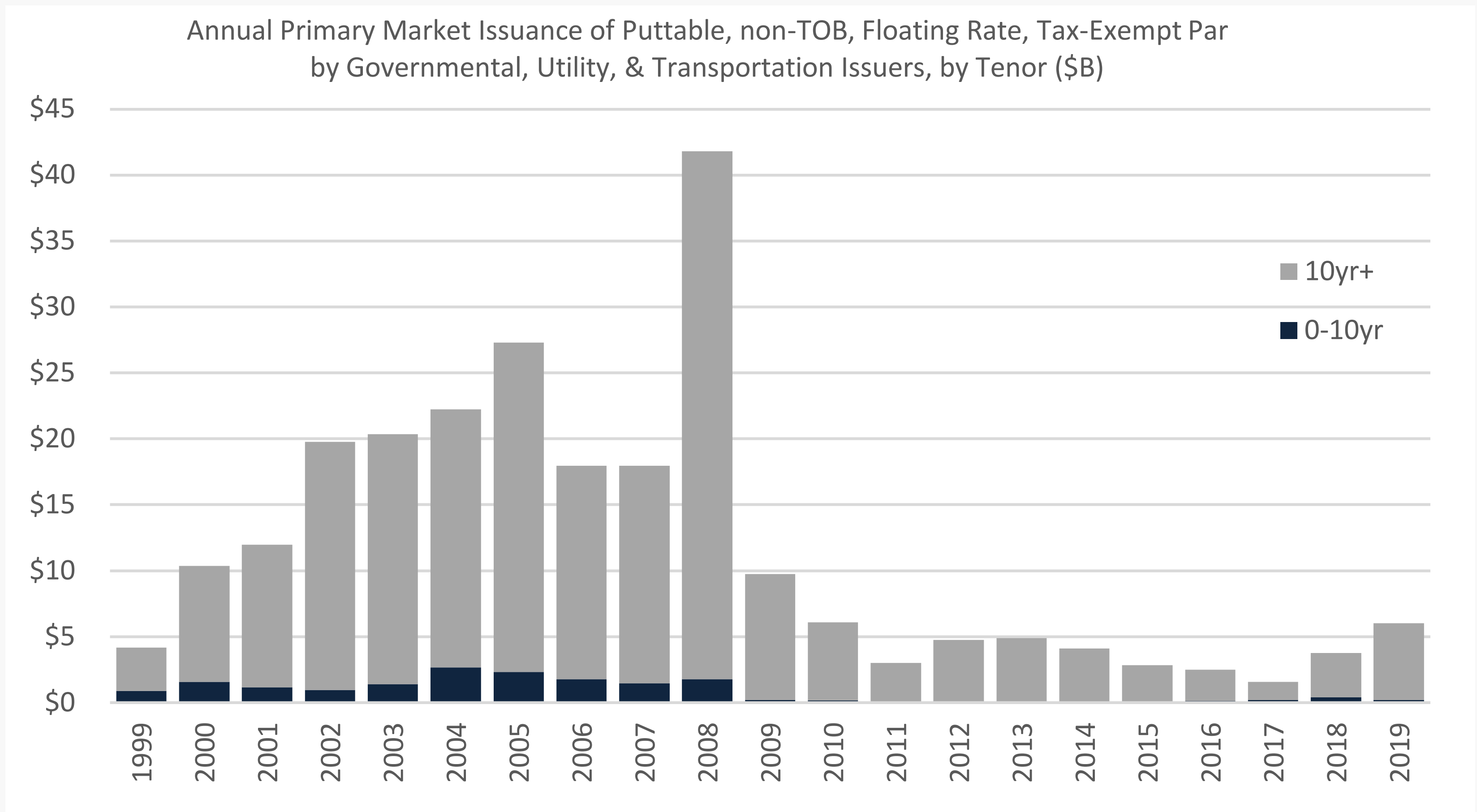
Clear that SEC reform catalyzed money fund outflows



But borrowing costs for VRDO issuers are not just the reset

- Also need the LF/LOC cost (~30-40bps per annum in 2016, but increases were happening with regulatory changes and capital requirements, a few decreases came later with competition)
- Plus remarking fees (~5bps), Plus rating fees (~5bps), Plus bond insurance fees sometimes; none of these are public or systematically available
- And governmental issuers were probably looking more to fixed payor swap costs than cash floating costs and/or basis mismatch with floating side of swap
- Any governmental issuer that was still running substantial exposure to VRDOs in 2016 was there for a reason, most likely a bad one (e.g., unaffordable swap termination cost, broken credit profile, etc.)

Governments' use of VRDOs reflected pre-crisis financial engineering & risk taking; post-crisis utilization has been tiny



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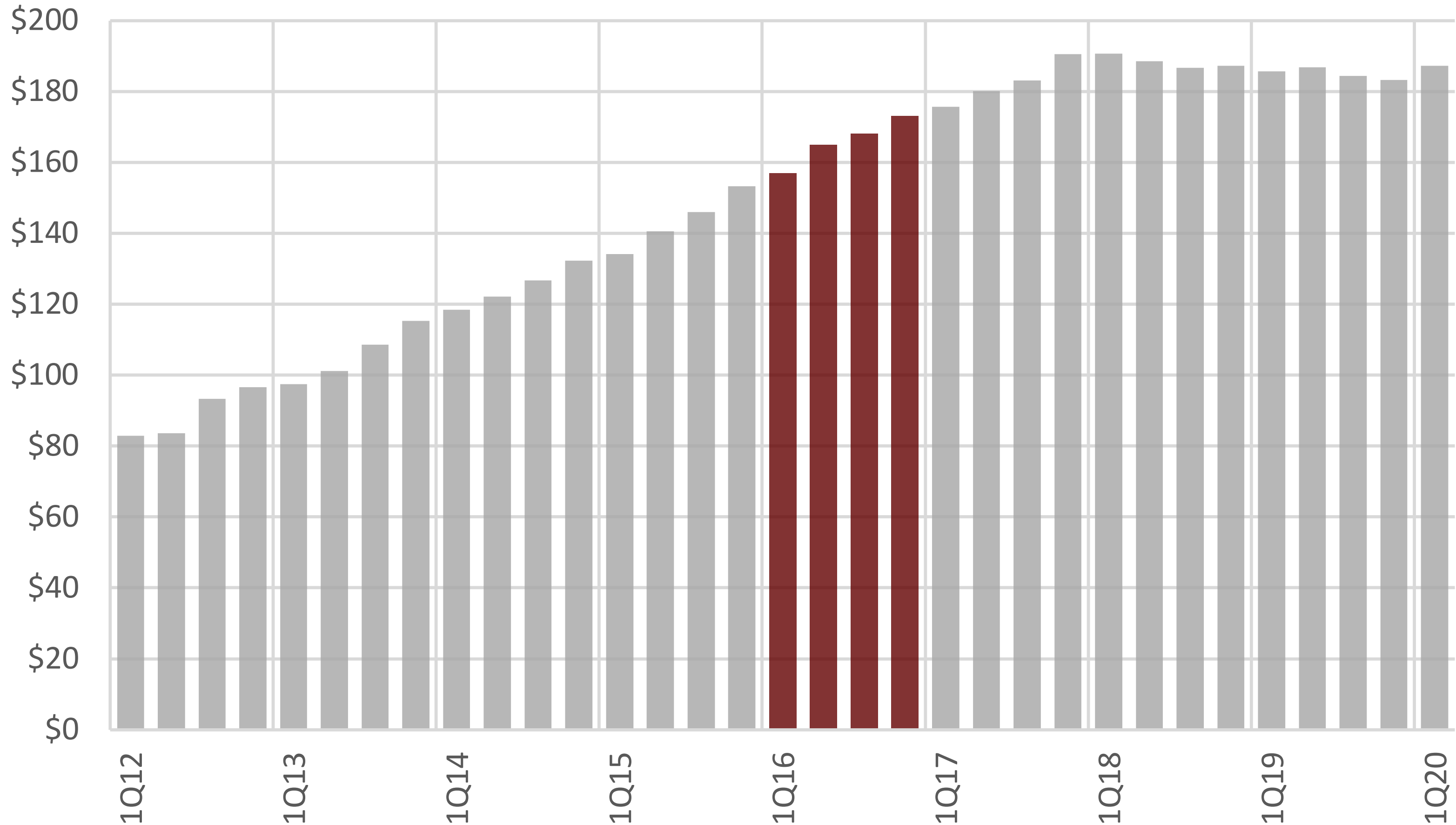
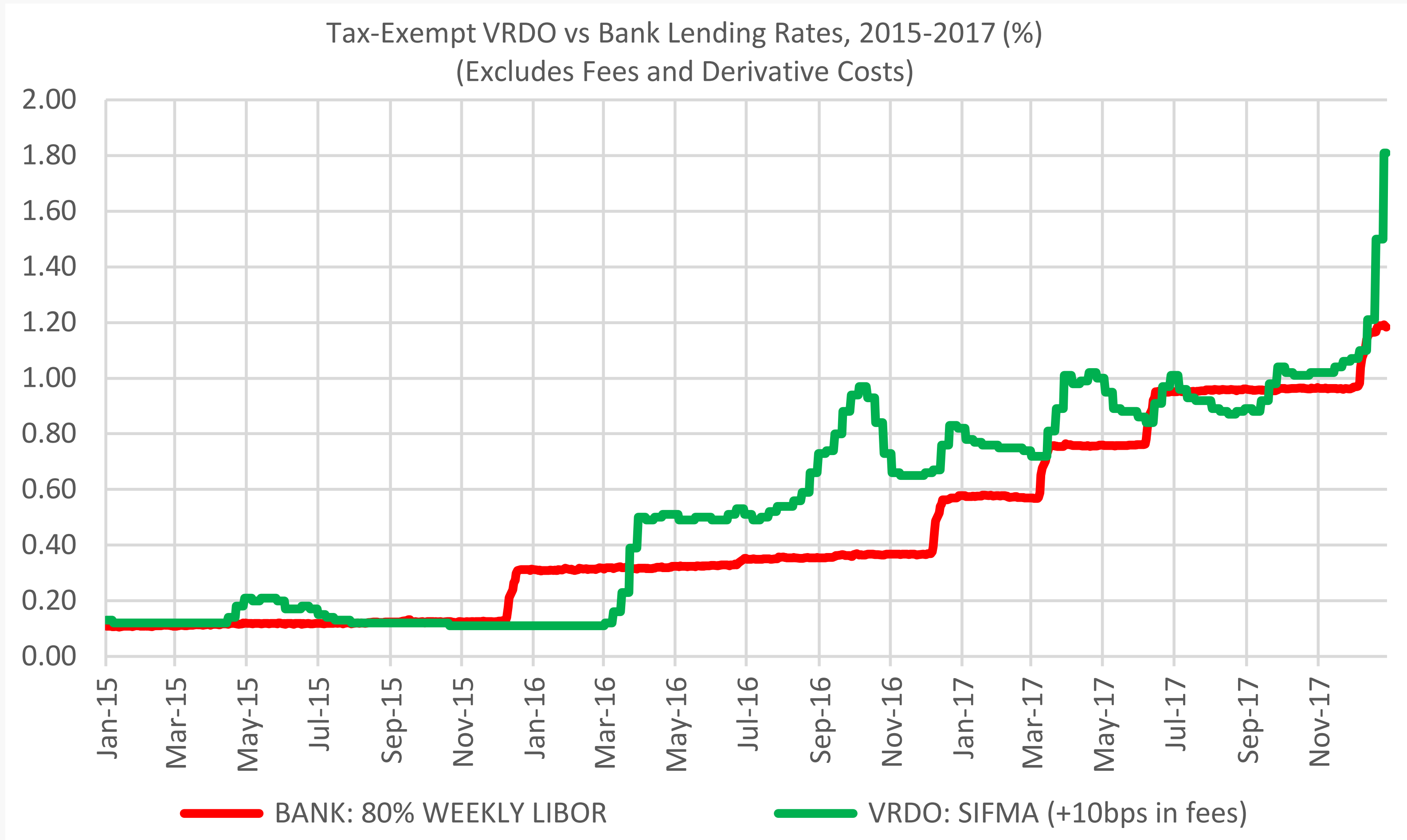
Banks helped make the change; capital requirements finalized in 2016 meant LC/LOCs were converted into direct bank loans



Taxable outperformance aided banks' argument: direct loans were both safer and cheaper for most governments



Nominal rate increases in this period reflected reduced money fund demand, but also other, more important factors

- T-E floating yields in 2015 and 2016 had run at abnormal lows, created by extreme and structural supply issues within the 2a7 market as
  - Governmental issuers abandoned derivatives (and thus VRDOs),
  - Banks converted entire LC/LOC programs into direct loans, and
  - Volcker Rule more permanently contracted remaining TOB universe
- The rate rise in late 2016 and 2017 also reflected macro & supply factors
  - The Fed started raising rates and Brexit happened,
  - New issue muni supply jumped (May-Nov) ahead of the election,
  - Strained budgets propelled note sales 37% higher in 2017, and
  - Any local governments still in VRDOs at that point skewed weaker than the average issuer

Incremental regulatory intervention can be constructive

- Money market funds were not the root cause of the financial crisis affecting municipals, but **money funds were the primary platform used by the products that were crisis vectors** (e.g., TOBs, issuer derivatives, bond insurance and bank ratings)

- Making money funds a little less useful to leverage-based investment vehicles has removed a major element of systemic risk within munis

- Primary users of VRDOs have been hospitals, housing authorities, and higher education providers: these tend to have more sophisticated management teams; TOB activity remains but is trivial vs pre-crisis

- Governments by and large use bank loans for floating rate exposure, and banks are heavily regulated by the Federal government, helping to address related knock-on risks that could accrue to borrowers