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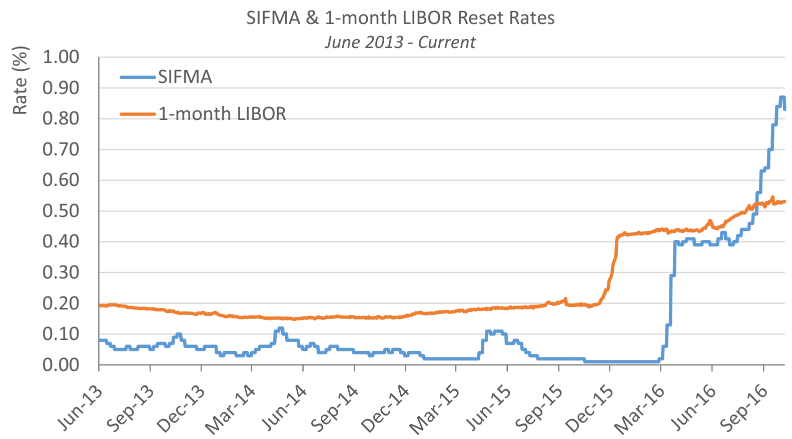
# Recent rise in SIFMA posing challenges for the short-term tax-exempt market

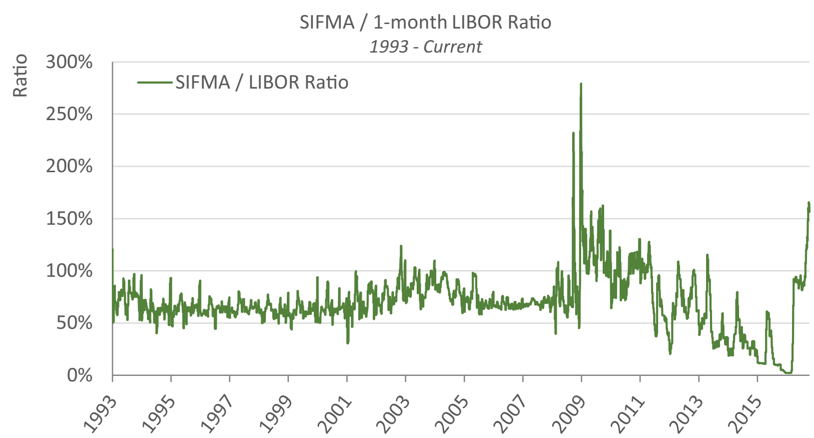
**From PFM Financial Advisors LLC**

## Introduction

Ahead of the upcoming implementation of additional Securities and Exchange Commission (SEC) regulations governing money market funds (MMFs), questions remain about the potential for long-term structural changes to municipal markets. With significant outflows from prime and tax-exempt MMFs, borrowing rates have become more volatile, leading issuers to reconsider traditional means of financing in the short-term market.

## Background




In anticipation of U.S. money market reform, which takes effect on October 14, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, a weekly reset rate designed to represent activity in the tax-exempt Variable Rate Demand Obligation (VRDO) market, has witnessed a significant spike in overall rate levels. Additionally, the SIFMA Index has become disjointed from its taxable counterpart, the 1-month London Interbank Offered Rate (LIBOR). After remaining largely stable at levels of less than 0.10% for the last three years, the rate on the weekly reset index began trending upward in March of this year, and as of October 12, has surged to 0.83%. Prior to March 30, the index's strongest uptick in the past five years was a 0.26% increase to the overall rate. At the same time, as illustrated in the charts to the right, the relationship between SIFMA (tax-exempt) and the 1-month LIBOR rate (taxable) has also spiked, with the ratio steadily moving beyond the more "normal" levels that the market has experienced historically into ranges that exceed 150% (SIFMA/1-month LIBOR). With the recent surge, the interest costs of short-term tax-exempt bonds is steadily on the rise, creating challenges for municipal borrowers.

The reasons for the recent spike in the SIFMA index are twofold — a supply-demand imbalance caused by imminent money market reform and, less significantly, the market expectation that the Federal Reserve (Fed) will increase interest rates before the end of the year. As the most recent move in response to the financial crisis of 2008, the SEC is implementing regulatory reforms to institutional MMFs registered under the Investment Company Act of 1940 Rule 2a-7. The new rules become effective October 14, and are set to fundamentally alter the ways in which MMFs currently operate. One of the most significant changes requires institutional prime (e.g., non-government) and tax-exempt MMFs to price and transact at a market-based, floating net asset value (NAV), instead of a stable price of $1.00 per share. Consequently, the price of these funds will fluctuate with changes in the market-based value of securities portfolios.

In order to avoid a "run" on these funds, the amended regulations require MMFs to temporarily suspend redemptions through the use of "gates" or impose redemption fees if a fund's weekly liquid assets fall below 30% of its total assets. The implementation of the MMF reforms by the SEC is rooted in an effort to increase the overall resiliency of funds during times of severe financial stress to the markets.

Ahead of these reforms, certain types of MMFs have experienced considerable outflows of assets. Since the beginning of 2016, prime and tax-exempt MMF assets, which the SEC's upcoming regulations target, have witnessed declines of 29% and 40%, respectively, as investors shift to stable-NAV government MMFs. Consequently, during the same period, inflows to government MMF assets have soared by 38%.

This shift from prime and tax-exempt to government MMFs has impacted the demand for VRDOs, the market for which will continue to be tested in the aftermath of MMF reform. Historically, these MMFs have been the core investor base for tax-exempt VRDOs, as the liquidity, credit, and put features of the securities made them attractive investments under SEC Rule 2a-7. However, as investors continue to move away from prime and tax-exempt MMFs, the natural investor base for tax-exempt VRDOs has diminished. The features that made VRDOs attractive to MMFs, including their liquidity and credit characteristics, should remain alluring to alternate investors, but the extent of this demand in the marketplace remains unknown. Currently, however, a supply-demand imbalance stemming from the recent outflows from tax-exempt securities, including VRDOs, has created an increase in short-term tax-exempt bond rates and a change in the relationship between tax-exempt and taxable short-term rates, as reflected in SIFMA's upward trend.

Another factor spurring movement in the SIFMA Index is the market expectation that a Fed rate hike is likely before the end of the year. The Fed has indicated that a rate hike is a strong probability if the economic data is cooperative, though this has yet to be the case. In July, Britain's unexpected vote to leave the European Union, or "Brexit," stalled any talks of a rate increase, as did the weaker-than-expected jobs numbers in August, when close to 30,000 fewer jobs were created than expected. Consequently, the market expectation that the Fed will raise short-term interest rates in the upcoming months looms large, partly contributing to the spike in short-term rates.

Key observations regarding the impact of recent market developments include:

- **Increased costs associated with outstanding VRDOs.** The outflows from tax-exempt and prime money market funds have contributed to higher costs for municipalities issuing, or with outstanding, VRDOs. In light of this trend, ongoing interest in the VRDO market continues to be tested, leading many municipal issuers to consider alternative financing methods, including direct bank loans and converting debt instruments from a SIFMA to a LIBOR-based structure. For governmental and public-sector entities seeking to avoid direct exposure to SIFMA and its recent movements, the direct loan market can serve as an attractive substitute. In recent years, the high expiration volume of liquidity facilities has led many municipal issuers to refinance outstanding VRDOs by converting those instruments into direct bank loans, leading to an increase in the availability of credit and liquidity. However, direct loans and VRDOs share many of the same risks, including renewal, acceleration and interest rate variability.

- **Long-term impact on swaps market remains to be seen.** While short-term tax-exempt rates have spiked significantly, the surge in SIFMA has not had a noticeable impact on long-term swap rates or in issuer/end-user behavior. Issuers that have LIBOR-based fixed-payer swaps have experienced a moderate increase in the basis mismatch due to the disjointed relationship between short-term SIFMA and LIBOR rates. As the implementation of money market reform occurs, however, we would expect to see this relationship gradually normalize. PFM Financial Advisors LLC (PFM) will continue to monitor the market for structural modifications that may impact municipal issuers.

- **Risk associated with SIFMA-indexed floating-rate notes (FRNs).** Borrowers with FRNs indexed to SIFMA are experiencing significant increases in interest rates. For those with unhedged FRNs, conversion to a fixed-rate bond while rates remain low may be an attractive alternative.

## Conclusion

Following the implementation of money market reform, PFM will continue to monitor the markets and keep municipal issuers informed of ongoing developments. In an effort to diminish the negative impacts on municipal issuers imposed by the pending MMF reform, bipartisan legislation has been introduced in both the U.S. House and Senate that would eliminate the floating NAV requirement for prime and tax-exempt MMFs. The bill, titled the Consumer Financial Choice and Capital Markets Protection Act, aims to restore liquidity to this market and preserve the low cost of financing for issuers and borrowers of short-term tax-exempt municipal debt. While the long-term impacts on short-term borrowing rates remain to be seen, PFM will assist borrowers in evaluating the benefits, risks and costs of traditional and alternative financing options given current market conditions.