

Preventing Runs with Redemptions Fees

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March 19, 2026

Overview

Big picture question: How can we prevent runs on financial intermediaries?

This paper: Redemption fees can prevent runs in a robust, simple way

Runs on MMFs

- ▶ Traditionally, MMFs offer redeemable shares at a fixed NAV of \$1
- ▶ Fixed NAV, makes MMFs prone to “classic runs”
 - ▶ Market NAV depends on redemptions at the end of the day
 - ▶ Asset liquidations reduce the value of the shares
 - ▶ If NAV drops below \$0.995 fund breaks the buck and is liquidated
- ▶ Promised amount does not fully incorporate liquidation costs
⇒ strategic complementarities

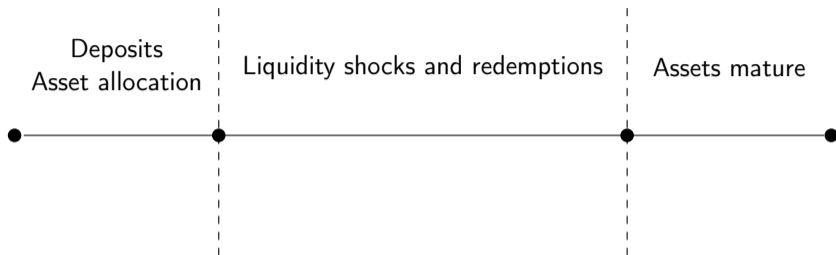
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- ▶ Calls for reform after runs on MMFs
 - ▶ 2014 (after 2008): Redemption fees when liquidity is low ⇒ Preemptive runs

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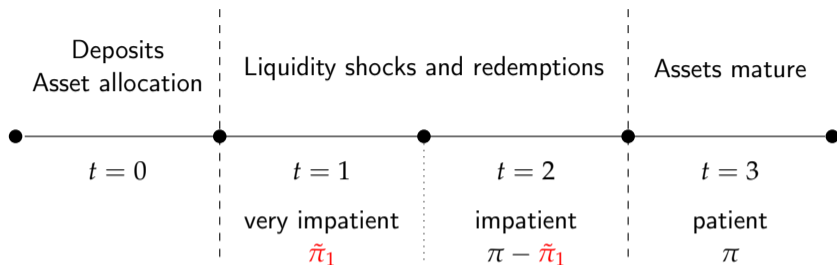
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- ▶ Calls for reform after runs on MMFs
 - ▶ 2014 (after 2008): Redemption fees when liquidity is low ⇒ Preemptive runs
 - ▶ 2023 (after 2020): Vertical slicing + liquidity requirements ⇒ Still not run proof

Almost a Standard Banking Model



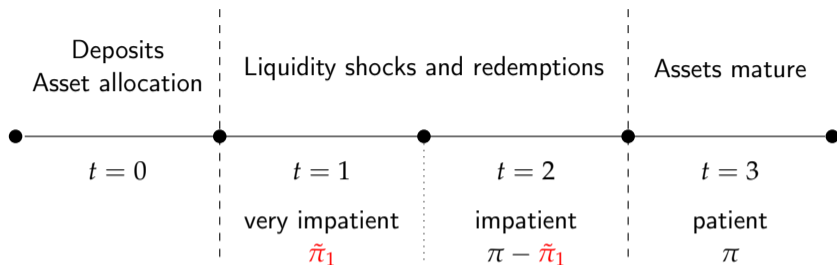
- ▶ Investors have 1 share in the fund and a fraction s is in storage and $1 - s$ is invested
- ▶ Invested goods yield $r_1 \leq 1$ at $t = 1$, $\tilde{r}_2 \leq r_1$ at $t = 3$, and $R > 1$ at $t = 3$
- ▶ Investors subject to liquidity shocks (private info) with demandable claims

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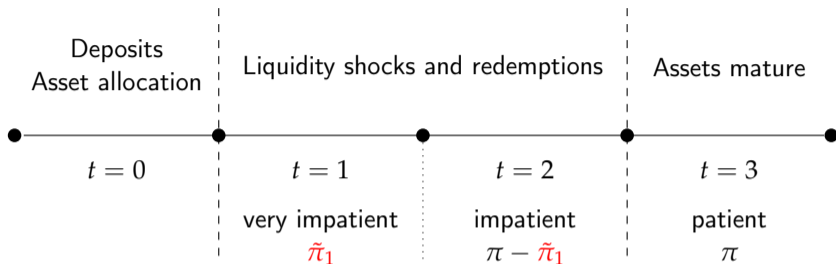
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- ▶ Only a fraction δ of non-type 1 investors can run at $t = 1$
- ▶ No sequential service: All redeeming investors at t get the same at the end of t

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- ▶ Can the efficient allocation be implemented in a *time consistent* way?
 - ▶ Yes! Unique implementation features fees off equilibrium
 - ▶ However, it is not always run proof intermediate δ (preemptive run)

Run-proof contract

- ▶ How can we attain run-proof contracts?
 - ▶ decreasing c_1 (reducing risk sharing)
 - ▶ making c_1 contingent on the state (m_t) to incorporate liquidation costs
- ▶ Optimal general run-proof contract features both
 - ▶ non-monotone fee schedules + multiple thresholds

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- ▶ Robust policies: run-proof for any δ and any distribution of r_2
 - ▶ 2023 reform: vulnerable and inefficient

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 - ▶ How close can one get with liquidity requirements?

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4. All crises in the model are liquidity crises!
 - ▶ LOLR would eliminate runs and could increase risk sharing
 - ▶ What about fundamental crises?
5. Finally, all this policy interventions would affect portfolio choices and the size of the MMF industry