ADDRESSING FUND LIQUIDITY RISKS
(MMFS, OPEN-ENDED FUNDS)

1. Addressing Money Market Fund (MMF) liquidity risks

1.1. Liquidity risks observed at the outset of the COVID crisis (March-April 2020)

An industry representative explained that MMFs are securities that invest in a wide range of short term assets thus offering diversification and transparency. Unlike cash placed in a bank, investors own the investments made by the MMF on their behalf, which means that they are preserved from the potential failure of the intermediary or asset manager. MMFs can also be considered as a first step towards longer-term investments and are therefore an important component of the Capital Markets Union (CMU). Reducing the use of MMFs would therefore reduce the diversity of saving instruments and of funding sources, hindering the proper functioning of securities markets and their potential benefits for the economy.

The industry representative stated that MMFs did not cause any significant liquidity problems in March 2020 and that the regulations put in place following the 2008 financial crisis helped to ensure that MMFs continued to perform adequately. They were however affected by the underlying short-term funding markets, which ceased to work as efficiently as normal. No MMFs were unable to meet their redemption requests and none needed to impose any fees or gates in March 2020, showing that tinkering with the MMF framework would not help to improve financial stability. In many instances, MMFs held significant liquidity that they were unable to use because their clients were concerned by the link that regulations establish between liquidity levels and the possible imposition of fees and gates.

A second industry representative added that the liquidity issues observed in March-April 2020 concerning MMFs were mainly triggered by a ‘dash for cash’ by corporates and were therefore not comparable to what happened during the 2008 financial crisis. Generally, MMFs remained resilient and this is in part due to the new money market fund regulation (MMFR).

A third industry representative stressed that not all funds experienced the same levels of stress in March 2020, which illustrates the need for potential reforms to the fund sector to be facts and data based, in order to avoid impacting the overall sector. In addition, despite the volatility experienced in March-April 2020, particularly in the underlying commercial paper (CP) market, Central Bank intervention tools to provide liquidity for such notes were actually used by very few in the industry. However, the existence of a potential backstop did enhance market stability.

The Chair observed that there being no failure of any MMFs in March 2020 could be argued to be due to the central banks stepping in to support the underlying short term market or MMFs directly. The key issue is defining how to ensure that in the future MMFs can continue to work properly in time of stress without relying on the systematic support of central banks.

A Central Bank official considered that the events of March 2020 exposed the frailties in the MMF market at a time of extreme stress in the financial system, which would have caused potentially very serious vulnerabilities had central banks not intervened very significantly. These vulnerabilities need to be tackled. At the core of this issue is liquidity mismatch, which has to be resolved because otherwise those frailties will be further embedded in the system. A regulator agreed that although MMFs did not contribute to triggering the crisis they would have run into severe difficulties had central banks not stepped in and there may have been a spill-over to other sectors as well.

The first industry representative however believed that in times of sudden episodes of stress it is up to governments and their treasuries or central banks to help calm the situation and to provide a regime in which the public can see that their savings are safe and available.

1.2. Regulatory proposals made for addressing pending MMF liquidity risks

The Chair suggested that the March 2020 events demonstrate the need to examine options for enhancing the robustness of the MMF sector and noted that three public consultations on policy options for reforming MMFs have been completed at the international level. These were led by the SEC in the US, ESMA for the EU and the FSB at the global level and the time has now come to deliver a ‘meaningful regulatory response’. The policy options presented in these three consultations are relatively similar and there was also a broad consensus in the answers received to the consultations. One option on which there is a wide agreement is the need to suppress thresholds in the regulation which trigger potential cliff effects and runs. Some other options considered concerning both liquidity management and the way to absorb losses could more profoundly affect the way the MMF industry is working. There was general disagreement in the responses to the consultations about loss absorption tools such as capital buffers and there were diverse views on how liquidity should be managed inside MMFs.

A Central Bank official agreed that the time has come to decide on a package of reforms for MMFs. On the asset side, there is a need to ensure sufficient liquidity as a buffer, which can be done by imposing liquidity requirements and public debt holdings. However liquidity buffers need to be of a sufficient scale and to be usable, avoiding cliff effects.

A regulator pointed out three problems associated with MMFs that need to be tackled. The first is that they are more exposed to run risks than other investment funds. The second is that a solution needs to be found with sufficient impact but without requiring reform of the entire MMF market, which would take several years to achieve. The third is that central banks cannot be the only market makers of last resort of MMFs, which would go against their mandate. Regarding run risk, it is probably easiest to address the question of whether there should be a Constant Net Asset Value (CNAV) component in MMFs. The second and third issues can be solved with liquidity management tools (LMT), which exist in the EU but have only been used rarely so far. This reveals a ‘bias to inaction’ at the investment fund manager level that has obliged central banks to take action in the past. Proposals concerning asset quality also need to be considered, including the possibility of daily or weekly liquidity requirements and also having part of the assets invested in public debt. While increasing disclosure and data provision is a further option to consider, the data from other sectors of the financial industry shows that this cannot be the only solution because of its poor quality.

An industry representative suggested that a complete review of MMFR is not needed. There could be targeted amendments for anti-dilution levies, for instance, but there is firstly a need for relevant data in order to evaluate the potential impact of different solutions. In addition, without a proper functioning of the short-term financing market there cannot be reliance on the data being accurate and transparent. The industry representative also emphasized one concerning question in the FSB consultation document relating to reforms targeting the asset side and eligible assets of MMFs and which does not appear in the ESMA consultation. This is not the correct route to follow because the liquidity crisis of last March had little to do with the quality of the underlying assets. MMFR has already defined a list of eligible assets, which enabled MMFs to enter the COVID crisis in a very good shape. Further changes to eligible assets should be considered with caution, because this may lead to a shortening of the funding horizon for issuers and may amplify the risk of overlapping positions across the different MMFs. The industry representative also suggested that Article 27 of MMFR on know your customer (KYC) policy[1] could be improved. There could be more detailed measures at Level 2 or 3, and possibly through an additional liquidity buffer depending on the result of the stress test or the KYC policy. The industry representative however opposed any minimum balance or any risk or capital buffer requirements, which may lead to the end of MMFs if they are fixed at an excessive level.

Another industry representative agreed that building up an additional buffer in MMFs seems both unnecessary and impractical, especially at a time of ultra-low interest rates. Reducing liquidity transformation, especially in short-term MMFs, also seems unnecessary. MMFs already follow strict rules in the EU that ensure that CNAV and Low Volatility NAV (LVNAV) MMFs have to maintain minimum balances of 10% of their assets on a daily basis and 30% on a weekly basis. There are also strict regulations and minimum levels in place regarding Variable NAV (VNAV) MMFs, which worked well in March 2020. Strict weighted average maturity and average life also have to be maintained. Realistically, the only amounts that the funds invest over 90 days tend to be about 20%. Even that is capped at 13 months, so very little transformation takes place there. Medium-term assets are not held, nor are mortgages or equity positions, because MMFs invest in short-term debt.

1.3. Role of Liquidity Management Tools (LMTs)

An industry representative noted that when the MMFR was negotiated there was a request by a part of the industry to have LMTs at their disposal, such as fees and gates, rather than a capital buffer. These LMT mechanisms were at the time specifically introduced to compensate the derogatory pricing methodology that is granted in MMFR for CNAV and LVNAV MMFs. Reviewing this would mean amending the Level 1 text, which should be avoided. One aspect that needs to be changed in MMFR is de-linking the imposition of fees and gates from the liquidity ratio. The cliff effect issues also needs tackling. Concerning LMTs the industry representative was open to adjustable exit fees if further measures are needed in this area, which should be presented in the legal documentation.

Another industry representative agreed that suppressing the link between liquidity levels and the possible imposition of fees and gates is a priority. When someone places money with a bank on a fixed deposit but wants their money back early, the bank will charge them for breaking the initial engagement. If, on the other hand, someone invests the cash in an MMF and asks for the money back, in normal times the fund will have sufficient liquidity to settle the redemption. If redemptions are higher than normal, MMFs already have, thanks to MMFR, methodologies for dealing with that situation. They can put a gate on the fund or charge the redeeming investor a fee equivalent to the cost of providing the extra funds. However that has yet to happen for EU MMFs, which have never had insufficient cash or been exposed to excessive price movements for CNAVs or LVNAVs.

A Central Bank official stated that redemption pricing mechanisms, such as swing pricing or anti-dilution levies that allow to get the liquidity premia priced in, need to be considered. Cliff effect thresholds have to be removed also since the buffer is actually acting as an enhanced trigger.

The Chair suggested that the tools aiming at suppressing first-mover advantage are important because they address both the issue of investor protection and also alleviate the risk of runs. Avoiding runs is essential from a macroprudential perspective because they amplify financial stability risks.

1.4. Responsibility for implementing liquidity measures

An industry representative suggested that LMTs should not be at the sole hand of the manager because there could be a stigma effect. Involving the

1. According to Article 27, the manager of an MMF shall establish, implement and apply procedures and exercise all due diligence with a view to anticipating the effect of concurrent redemptions by several investors, taking into account at least the type of investor, the number of units or shares in the fund owned by a single investor and the evolution of inflows and outflows.

macroprudential authority does not seem appropriate but it should be considered whether the national competent authorities (NCAs) can play a role, taking into account the fact that accurate data e.g. on the short term funding market is necessary to evaluate whether the conditions are met for using this type of instrument.

A second industry representative stated that fund managers, through their board of directors, have a duty of care to the regulators and also to redeeming and remaining shareholders for implementing such tools and the regulations dictate the conditions for putting them in place. Fund managers are also best placed to react quickly and fairly to ensure the best outcome for all clients. Regulators should be informed promptly of any such action being taken, but to ensure that timely decisions are made based on an in-depth knowledge of both the fund and its clients, that decision must be made by the fund manager. Additional KYC requirements could also be beneficial.

A third industry speaker felt that portfolio managers are best-placed to assess the situation in connection with the regulators, taking into account the specific characteristics of the portfolios in terms of liquidity profile and of the underlying investors. It is also essential that regulators ensure that an appropriate and operational toolkit is at the disposal of portfolio managers for managing liquidity risks.

A Central Bank official noted that there needs to be a move from a view of the market mainly focused on investor protection on a fund-by-fund basis to a more collective approach that incudes financial stability considerations. The macroprudential authorities have to be fully involved in this approach because fund managers cannot, by definition, see the full implications of decisions or actions at market level. As demonstrated in the previous crisis, while individual actions may be adequate for a particular fund or management company, this may not be the case for the overall market. The relevant levers and triggers therefore have to be in the hands of public authorities with the macroprudential authorities at the heart of the decisions.

2. Improving the liquidity of underlying short-term paper markets

The Chair noted that the liquidity of commercial paper (CP) and certificates of deposit (CD) markets in which MMFs invest is very poor, as well as the liquidity of many short-dated treasuries especially in stressed times. The question to address is whether significantly improving the functioning and liquidity of these short-term paper markets is feasible and to what extent that could contribute to improving MMF liquidity. The characteristics of the short-term paper market also need to be taken into account. It is a buy and hold market much of the time with a secondary market less active than the bond market for example. In addition Basel III requirements will continue to restrict the capacity of market makers to increase their books.

An industry representative suggested that improving the trading and the functioning of the short-term paper market would contribute to mitigating the risks that may reside upstream in the investment process of MMFs. This requires first a better understanding of the liquidity on those markets, based on robust data. One issue to note regarding the volatility of the short-term notes in particular is that the key concern the previous year was less about the quality of the securities, or a fear that investors would not be paid back, and more an issue with banks' or brokers' balance sheets not having enough room to buy those securities from the funds, largely due to capital liquidity requirements imposed on them after the financial crisis. The same dynamic was observed in the more liquid US treasury market. In this context it is important to define the right balance of safeguards needed to ensure the robust operation of the short-term paper markets and the potential constraints that may act as an impediment to buying high-quality assets, which could further deteriorate the liquidity conditions.

A second industry representative considered that improvements can be made to the short-term financing market and that this should be done before considering targeted amendments to MMFR. Improving the short-term financing market should also be a priority for the CMU. One recommendation is to have more transparency and standardisation of money market instruments and reduce fragmentation through the launch of a pan-European money market. Secondly, the development of a repurchase agreement (repo) market of CPs should be facilitated. Thirdly, best practices existing at the national level should be considered, such as the Negotiable European Commercial Paper (NEU CP) initiative put in place by the Banque de France supporting the financing of corporates. Fourthly, there should be facilitation of the use of money market instruments as a means to access central bank liquidity and therefore broader eligibility of CPs to central banks.

A third industry representative emphasised that improving the functioning of securities markets should be focused on, rather than 'punishing' market makers and intermediaries with high capital requirements or considering closing markets when volatility rises too much. Improving the functioning and liquidity of short-term funding markets must be the priority in this regard. At the same time there needs to be a significant increase in transparency in these short-term markets for all market players, both buy-side and sell-side, particularly in times of stress. There should notably be more transparency on programmes and outstanding volumes, as this would improve the asset valuation and risk management processes. Like the Federal Reserve in the United States, the ECB should also consider the creation of a permanent, standing repo facility that would be a market-based solution to support a smoother functioning of short-term funding markets.

Concerning the idea of reforming the underlying short term paper market, a Central Bank official stated that the regulatory community has to deal with the market as it is now. The priority is to put in place a framework that addresses vulnerabilities at the heart of the MMF market. However, in doing that, thought should be given to how the underlying market can be improved in order to ensure resilient liquidity.

3. Addressing open-ended fund (OEF) liquidity risks

The Chair explained that the regulatory work in terms of financial stability is less advanced for other OEFs than for MMFs due to the heterogeneity of their profiles, and probably also because they are perceived as less risky in terms of financial stability. Nevertheless, the work is progressing.

An industry representative observed that the previous year's market turmoil, which affected the whole of financial markets and not just funds, was a real-time stress test for the asset management sector. ESMA highlighted in a report in November 2020 that only a limited number of OEFs (around 0.2%), suspended subscriptions and redemptions in March-April 2020, while the vast majority were able to meet redemption requests and maintain their portfolio structure, which demonstrated the level of resilience of the sector. Specific segments of the funds industry were however faced with either valuation constraints or large-scale redemption requests and investor outflows.

Regarding the response of the OEF fund sector as a whole, the industry representative considered that the agility and efficiency demonstrated in the EU is largely due to two factors. One is readiness and the other is the existing robust liquidity toolkit derived from the regulatory framework. Readiness is linked to the fact that under UCITS and AIFMD requirements the fund industry, in close coordination with the regulatory authorities, regularly scrutinises how portfolios can operate under stressed market conditions, in particular in relation to liquidity risks. This regular liquidity stress testing exercise is very valuable, as has been the dialogue with regulators. In addition the high-level guidance from ESMA, in combination with the specific approach and supervision of the local authorities, the latter having proximity to the local markets and liquidity conditions, remain a key point in this context and can also help to provide aggregated information for regulators across Europe. The existing liquidity management frameworks of the UCITS and AIFMD Directives also played primary roles in the resilience shown by the fund sector in Europe. In particular, the process and wide range of LMTs at the disposal of fund managers to deal with different conditions have been key lines of defence, allowing for a calibrated approach that focuses on the portfolio composition and the underlying securities of the liquidity profiles. This demonstrates how important it is to ensure that a full toolkit is operational for use at the discretion of the portfolio manager.

In relation to the next regulatory steps concerning OEFs, the industry representative suggested that the focus should be kept on those areas where gaps and inefficiencies have been demonstrated. Firstly, that means ensuring that the wide range of liquidity tools listed in the asset management legislation are available and operational in every national jurisdiction. Secondly, ensuring that appropriate information is available during periods of stress is critical, not only from the industry to supervisors but also between NCAs and towards the European regulators. Thirdly, a cautious approach should be taken when considering further additions to prudential tools that go beyond fund-based liquidity processes. Trying to impose a one-size-fits-all approach as additional layers of regulations for all OEFs, with no distinction for their specific segments, in order to address the specific conditions and rules caused by particular actors in specific market segments could lead to ineffectiveness and unintended pro-cyclical risks.