MMF liquidity risks: remaining vulnerabilities and regulatory changes proposed

1. Remaining vulnerabilities associated with money market funds (MMFs)

The Chair introduced the discussion by noting that Europe saw a wave of redemptions with 'dash for cash' episodes in March 2020 at the outset of the Covid crisis, particularly in some types of MMFs. Central banks intervened and restored confidence in the market, avoiding systemic risks, but this type of intervention cannot be reproduced for each crisis. Work is underway to determine how to reform the MMF regulatory framework in order to ensure further financial stability and investor protection.

1.1 Vulnerabilities from MMFs identified in March 2020

An official remarked that EU MMFs experienced outflows also in January and February 2022 and explained that MMFs are structurally subject to an underlying tension. This tension is that on the one hand MMFs have deposit-like features, so people would like to use them as liquid instruments to deposit their cash and be able to draw from them at any time, and on the other hand they have fund-like features with a portfolio of assets to manage, which at times can become less liquid. MMFs are exposed to redemption risks every time there is a severe tension in the financial system, resulting in elevated liquidity needs. The strong inflation in the United States and the current situation in Ukraine are creating a new real-life stress test for MMFs. Significant outflows have been taking place in the US.

A regulator observed that there are real-life experiences in the sterling MMF markets that show material outflows in crisis situations but this does not necessarily mean that MMFs are doomed to fail each time there is a crisis. In the 10 or so days of stress in March 2020 there were MMF outflows of about 10%. The assets that are used to back the funds in the US are different from those used in Asia and in different parts of the EU, but there have been vulnerabilities in all regions that have placed these funds at susceptibility to disruptive redemptions. MMFs backed by private assets are mostly the area where regulators need to focus their attention. There were issues with first mover advantage and also the fact that some investors were not fully aware that low volatility NAV (LVNAV) MMFs posed potential market and investment risk.

Another regulator stated that in Belgium, which is an active fund market, there were some redemptions of MMFs and other types of funds, but no major movement. This is possibly due in part to the fact that the Covid crisis was not a financial crisis, unlike the 2008 crisis, but an external event that impacted the financial sector. When looking at the overall EU market, the Covid crisis shows that the risk remains of large redemptions out of funds that provide liquidity facilitation, as do MMFs, but not all MMFs were impacted in the same way. Differences were due to the underlying assets rather than the fund structure. Constant NAV (CNAV) and low volatility NAV (LVNAV) MMFs holding primarily non public debt experienced the highest outflows, whereas those holding mainly public debt experienced significant inflows. This can also be explained by the fact that the stress was emanating from the real economy.

A Central Bank official noted that the regulatory restrictions on MMFs had a cliff effect at the outset of the Covid crisis causing a dash for cash. When looking across the MMF sector and different jurisdictions there was clearly a first mover dynamic. This shows that MMF problems have possibly been 'over-fixed' following the financial crisis.

An industry representative observed that March 2020 was the first test of the MMF reforms implemented following the 2008 crisis and they generally fared well. One of the issues that needs to be addressed is the tying of liquidity fees and gates to liquidity thresholds, which put an excessive focus on maintaining buffers and created a holding back of cash which could have been leveraged into the market. High redemptions are not bad as such, because money in a fund is supposed to be redeemed and MMFs met redemptions in March 2020.

Another industry representative agreed that there was an ill-conceived regulatory incentive to redeem because of the linkage between regulatory liquidity thresholds and the obligation to impose a fee or a gate. If that issue is tackled, that will solve the vast majority of the perceived vulnerabilities associated with MMFs. The MMFs managed by the speaker's company held between 30% and 45% of weekly liquidity that they were not able to use in March 2020, because of this linkage. MMF holders withdrew money to face margin calls and to pay salaries and invoices at a time when no money was coming in from sales.

The Central Bank official agreed that redemptions are not bad per se, but they are problematic when they amplify systemic risk or when there is a sudden stop in funding. That is the aspect that should be focused on. A regulator added that while redemptions are not an issue, the first mover advantage of redeeming investors is problematic, especially in a stress event, because of the cost that is imposed on the investors who are left in the fund, the dilution impact they face, and whether they are aware of this.

A regulator added that it is also important to consider why investors came out of MMFs. A study published by the European Central Bank (ECB) suggests that the need to meet margin calls contributed to this outflow, but there may be other factors which require further analysis.

1.2 Central Bank intervention

An industry representative observed that in March 2020 the support provided by central banks was not driven by MMFs but by the objective to support short-term markets which were facing an external shock. These markets needed to be unfrozen, because the economies were shut down by governments. MMFs are the only transparent part of the short-term funding ecosystem and acted in March 2020 as a symptom of some the problems of the underlying short-term markets, which caused or amplified the liquidity issues experienced by certain MMFs.

An official emphasized that central banks intervened to keep short term markets functioning, including MMFs - i.e. not only MMFs but also MMFs - responding to vulnerability in the financial system. Huge liquidity imbalances in funding markets were indeed observed at the outset of the pandemic that affected entities that run liquidity mismatches, including MMFs. A regulator confirmed that saying that central banks did not do anything to support MMFs would be a misrepresentation. Compared to previous crises, the fact that MMFs had to be included this time in the scope of central bank intervention is a relevant factor.

A participant in the audience observed that the papers of some LVNAVs at least did not directly benefit from central bank programmes because of their characteristics, they were high quality, mostly commercial paper (CP). The central bank intervention was nevertheless critical in allowing a re-opening of primary markets and benefitted MMFs indirectly at a time when the investors who were redeeming out of MMFs needed the cash because they could not issue their own CP the market.

2. Measures proposed to address the systemic risks posed by MMFs

The Chair stated that a number of proposals have been made by ESMA and the FSB for tackling the issues faced by MMFs. These include policy options such as decoupling regulatory thresholds from the activation of redemption gates, the use of liquidity management tools (LMTs) and liquidity buffers, stress testing and reporting requirements, and changes related to the use of amortised cost in some specific types of low-volatility MMFs.

An official outlined that the FSB has approached the tackling of MMF vulnerabilities from a global perspective. As a first step it assessed a comprehensive set of policy options to enhance the resilience of MMFs based on four mechanisms: (i) imposing the cost of redemptions on redeeming investors; (ii) reducing threshold effects; (iii) reducing liquidity transformation in MMFs; and (iv) allowing MMFs to absorb losses. The second step was a recognition that the prevalence of MMF vulnerabilities and the appropriateness and effectiveness of different policy options may vary across jurisdictions, depending on market structures and the use and characteristics of MMFs. A set of policy options has been developed that FSB members have committed to consider in addressing the issues identified in their jurisdictions. The third element was to consider the need to take a global perspective to the financial stability issues associated with MMFs. The FSB and IOSCO will review progress made by member institutions in adopting reforms to enhance MMFs resilience, and look at issues like inconsistencies, cross border effects, and potential regulatory arbitrage. The Chair agreed that policy options need to be adapted to the specific circumstances and that there cannot be a one-size-fits-all approach.

A Central Bank official emphasised that policy thinking about MMFs needs to start with an analysis of the economic purposes that are being served by MMFs, which are the short-term funding of the economy and cash management. There is a strong consistency between FSB proposals made at the international level and the proposals made in Europe. Addressing regulatory cliff effects is essential in particular and needs adequate risk-based reporting. The regulatory approach also needs to be different for MMFs and other open-ended funds, because of the timelines, the pricing and the valuation structures in MMFs.

2.1 Liquidity management tools (LMTs)

A regulator was supportive of a wider and more consistent use of LMTs among the range of options available to address MMF vulnerabilities. Where LMTs were available, there was a very inconsistent application of them, and perhaps not even a proper understanding by all managers as to how they could be used. A regulator noted that there are still obstacles to the use of LMTs at present that need to be lifted. In Belgium for example, fund managers still need to be convinced of the usefulness of these tools and there is still a law to be changed to allow LMTs to be activated in one day without passing through the General Assembly.

An industry representative was favourable to an amplification of the use of LMTs, particularly liquidity fees and anti dilution fees. Swing pricing works when the fund sells portfolio assets in the market to meet redemptions, but does not work when using cash on hand, which is how the MMF structure works. Another industry representative observed that using LMTs is not usually necessary when funds have high levels of liquidity. Regarding swing pricing, although it is always useful to have an extra item in the toolbox, it is unlikely that it will ever be used for MMFs. The only way to use it is after the position of the fund has closed and after all of the price movements have been seen, which will be too late in most cases to adjust the NAV and manage investor payments.

A Central Bank official reiterated that the first mover dynamic is at the heart of the financial stability issues in the fund sector. Although the underlying drivers of this dynamic still need to be fully clarified, it involves redeeming investors externalising the costs of their redemptions on other investors. Swing pricing can solve that problem without having to go to some of the other possible solutions in the open-ended fund segment, such as liquidity buffers and redemption periods. The effective use of LMTs in general however still faces many challenges in terms of appropriate calibration and timeliness and this is the case also for swing pricing. Concerning MMFs it is good to have swing pricing as an option, although further work is needed to define how it may be used in an effective way for these funds.

The first industry representative supported the use of swing pricing for open-end funds in general. There are two different types of first mover dynamics, one is against the market and the other against the fund. No liquidity measure such as swing pricing is going to address a first mover advantage against the market, because when investors want to redeem because the market is moving in a certain direction or because they want more liquid assets in their portfolios, as in dash for cash situations, they will not be stopped by a liquidity measure. Where swing pricing is effective is in limiting the effect of a first mover dynamic on the fund and the remaining shareholders, but in the case of MMFs its operationalisation is not feasible for the reasons previously mentioned and trying to do so would have adverse effects on MMFs.

2.2 Liquidity buffers

A Central Bank official considered that enhancing liquidity requirements is also vital and supported the inclusion of a requirement for the holding of public debt as part of the liquidity buffer of MMFs. The economic objective would be to try to ensure as little disruption as possible in times of stress in the short-term funding of corporates and financial institutions.

An official explained that regulators are generally favourable to the inclusion of the holding of public debt in liquidity requirements, because they want to reduce the features which make MMFs resemble banks and to strengthen those which make them more like investments, also making sure they can continue to perform their function in times of stress without the need for central banks to step in. This is why MMFs need to have a stronger liquidity base and public debt is the most liquid type of asset. Additionally, mandatory public debt holdings may create additional demand for MMFs, since they would become a more liquid and safer instrument. Mandatory debt holdings are one of the measures envisaged in the 2021 ESRB Recommendation on MMFs.

An industry representative observed that the decision of European regulators to stay away from prudential requirements for a capital market instrument such as MMFs was appropriate. However imposing public debt holding requirements does not seem necessary for enhancing the liquidity and resilience of MMFs and may create unintended consequences, because it may hamper portfolio management and embed potential volatility into the fund. Liquidity requirements should not mandate the type of liquidity held by MMFs. In Europe there could be limitations to what types of sovereign could be put into portfolios, which may create other issues. The industry representative added that while building up the liquidity of portfolios is important, the decoupling of liquidity fees and gates from liquidity requirements should be the priority, because this connection did not work in March 2020.

2.3 Reviewing LVNAV funds

A Central Bank official emphasized that LVNAVs are the main type of MMF which needs to be reviewed in the EU. 46% of the European MMFs sector are LVNAVs, and they had a significant impact in March 2020. The benefits they provide, why corporates buy them and what should be the adequate policy approach to them needs to be further assessed. In the 10-day period of outflows in March 2020 the collar requirements[1] for LVNAVs had an exacerbating impact, and increased stress regarding these MMFs. A solution needs to be found to address that issue without leading to the discontinuation of LVNAVs. It is important to think about the characteristics of LVNAVs and their main vulnerabilities, given the redemptions that were observed. The likely solution is in reviewing how the rounding of the NAV is done and how there can be movement away from an amortised cost approach.

An industry representative stressed that one of the options that is being considered for LVNAVs, which is their discontinuation, seems too blunt, because removing these funds from the market would take away an important source of liquidity for which there is no substitute, given the constraints imposed on bank balance sheets. Moreover the March 2020 data shows that LVNAVs met redemptions, stayed within bands, and showed no acceleration of redemptions, which does not justify discontinuing them. A connection is made in the ESMA paper between the amortised cost and the rounding of the NAV, but there is no reason for that. LVNAV funds can be run mark-to-market without using amortised cost.

A regulator proposed removing the possibility of using amortised costs in accounting for LVNAVs, which is an option that had already been considered during the first round of negotiations about the MMFR. The question is what the impact will be and whether it will be a game changer for LVNAV MMFs.

3. Issues raised by the underlying short-term markets

Answering a question from the Chair about the need to reform underlying short-term markets, an industry representative observed that if the underlying markets to MMFs i.e. commercial paper (CP) and certificates of deposit (CD) do not work, then a key part of the ecosystem is not functioning. A more holistic approach is required instead of focusing on perceived vulnerabilities in MMFs, policymakers must improve and enhance the short-term funding markets in tandem with policies regarding MMFs. The first thing to do is to improve transparency.

1. The MMFR sets out a strict threshold for LVNAV funds in the form of a NAV collar. LVNAV funds can be purchased and redeemed at a constant NAV, but this is only possible if the difference between the fund's constant NAV and its marked-to-market NAV is no greater than 20 basis points (the "20 bp collar"). In the event that an LVNAV breaches this 20 bp collar (i.e. its marked-to-market NAV deviates by more than 20 basis points from the constant NAV), the MMFR requires the fund to value its assets using variable pricing.

The second aspect is to enhance automation and harmonisation in these markets, which are at present over-the-counter (OTC) markets with lengthy transaction delays. In addition the third aspect is about the need for deeper and more liquid markets, which requires moving towards an all-to-all market i.e. making these markets enter the 21st century. The fourth aspect resorts to central banks whose function, among others, is to ensure these markets do not freeze when they are most needed; i.e., central banks should put in place a standing repo facility that market players can use.

Another industry representative agreed that more standardisation and transparency are needed in the short-term market, even though it functions relatively well in normal conditions. Moving to an all-to-all trading platform in Europe, in the same way as the US, is a difficult question however, because that means having one central source of liquidity, which can be an issue during times when nobody is buying as in March 2020. Other ways must be thought of to ensure that the market has more sources of liquidity, and also that the interconnectedness of the market is clearly recognised. Because MMFs are the most transparent part of the short-term market ecosystem, they are under the spotlight, but they are only one part of the ecosystem.

An official stressed that the broader ecosystem of short-term markets is discussed at FSB level and was mentioned in last year's report about MMFs, but one needs to be realistic about what can be done. The main point is that actions to increase the liquidity of short-term funding markets can complement measures to address the structural vulnerabilities of MMFs, but cannot be a substitute for them. In addition improving the liquidity of short term markets is quite challenging. The secondary markets for CPs and CDs are structurally illiquid. In addition, dealers have limited economic incentives to make markets in these short dated instruments, even in normal times, as their illiquidity is the direct result of the characteristics of the instruments. Three main areas that could be considered to make improvements to the liquidity in short-term funding markets were however mentioned in the FSB report. These include (i) changes in the market microstructure with e.g. increased standardisation, faster settlements, paperless processes, electronic all-to-all trading platforms, (ii) increased market transparency and (iii) enhanced regulatory reporting that may enhance the ability of authorities to monitor trends and risks across the whole ecosystem.

A regulator stated that MMFs only represent 30% of the total assets of the short-term paper market and this proportion has strongly decreased compared to 2008. This means that it is important to pay attention to the underlying short-term funding market when tackling the systemic issues raised by MMFs. There needs to be a balanced approach, which is quite a challenge at the global level. Regulators need to be able to find the right balance between enhancing the resilience of MMFs and keeping the MMF market alive, and between measures concerning the underlying short-term markets and the MMF product itself. The situation is not the same across jurisdictions and short term funding markets, such as repo markets, CP and CD markets function in different ways, but cooperation is needed at the international level to address these issues. IOSCO is very conscious of these challenges, which is why it will start working with the FSB in the last quarter of 2022 to explore the short-term funding market in greater detail and assess differences across regions.