Vulnerabilities from non-bank financial intermediation

1. Remaining vulnerabilities from non-bank financial intermediation

1.1 Liquidity risks

The Chair stressed that, with the significant growth of non bank financial intermediation over the last few years, the vulnerabilities created by these activities are a regular subject of debate. In the United States, the latest figures show that the non banking sector now provides more credit than the banking sector. This is not currently the case in Europe, but it illustrates the changing nature of the dynamics in the financial sector and the importance of considering the potential implications of this evolution for financial stability in the context of rising market stress. Liquidity mismatch issues create substantive vulnerabilities within the investment fund sector in particular, and the stress events experienced since 2008 demonstrate the importance of addressing these issues. The fact that central banks had to intervene significantly in March/April 2020 in the short term funding markets that underly money market funds (MMFs) shows that further actions may be needed to ensure resilience in the non-bank financial system.

A Central Bank official agreed that there was serious cause for concern in 2020 due to the large scale and widespread redemptions observed across a large part of the MMF sector. During that period, reporting data had to be escalated quickly because investors were making persistent large scale redemptions. This could be called a 'dash for cash', but these redemptions corresponded to many different business needs. MMFs are used by investors to meet their treasury needs and for a variety of other reasons.

1.2 Implications of changes in the macroeconomic and monetary environment

The Chair observed that high levels of inflation, rising interest rates and the probability of a recession in the months to come will be difficult challenges for the public authorities and also for the financial industry, including the asset management sector.

An official emphasised that MMFs have some structural features that make them vulnerable in stress situations. There is a need to solve this problem, possibly with a stricter policy approach to MMFs, before any further central bank intervention is warranted. It is in the interest of the industry to preserve a situation in which business can be maintained without causing financial stability risk. The ongoing increase in interest rates offers a window of opportunity to reform MMFs. Historical trends in the US over the last 20 years show that the MMF market has grown each time the Federal Reserve has increased interest rates, albeit with some lag. European MMFs have not yet experienced significant inflows in aggregate terms since rates started to rise, but this should happen, based on the US experience. Fundamentally addressing MMF vulnerabilities seemed difficult when interest rates were low, but with interest rates increasing there is an opportunity to amend the legal framework for MMFs without hurting the market. A sudden strong rise in interest rates can lead to mark-to-market losses in funds holding debt instruments, but MMFs are less exposed to this risk than other funds, because they are required to keep their duration low. In the first half of 2022, MMFs significantly reduced the weighted average maturity of their portfolios from 44 days to 30 days, which is a three year low. On the other hand, rising rates, accompanied by heightened market volatility, pull capital towards MMFs because the yield being offered is higher. MMFs also provide more certainty for investors who are worried about market risks than some other fund categories.

The official acknowledged that the sheer number of risks emerging at the moment may dilute the sense of priority for policy intervention related to MMFs. However, if no legislative action is taken, MMF vulnerabilities will have to be tackled by the next Commission and Parliament, which means that MMFs may create financial stability risk in the interim. The Commission should make a proposal for reviewing the Money Market Funds Regulation (MMFR) so that the political process can start under the current legislature. It is essential that these discussions are not further delayed. MMF vulnerabilities are well known and a number of authorities have already issued recommendations, including the European Systemic Risk Board (ESRB), the European Securities and Markets Authority (ESMA), Financial Stability Board (FSB) and some national authorities.

An industry speaker observed that changes in interest rates are not particularly relevant for the management of MMFs. The interest rate environment has changed markedly in a short period of time, not least due to the European Central Bank's (ECB) unprecedented hike of 75 basis points. Tweaks have been made by asset managers to manage interest rate risk, which mostly means reducing duration in funds. There is a need to monitor flows very carefully. Whilst there have not yet been significant inflows to MMFs, this will change if investors see more competitive rates from MMFs compared to leaving money in a bank or savings account. Although there is no strong need for a connection between regulation and the present market cycle, policy-makers should move ahead with the most relevant and impactful reforms while preserving the potential of MMFs.

2. The impact of MMFR and areas of improvement

2.1 The overall performance of the MMFR framework

Answering a question from the Chair about the level of common understanding of MMF issues between the industry and policy-makers, an industry representative considered that the positions are now much closer than when the MMFR was initially developed. The MMFR was introduced just over five years ago, and it has provided remarkable resiliency for the EU MMF sector during two of the largest live stress tests imaginable, the pandemic and the Russian invasion of Ukraine. With MMFR mandating that all MMFs should hold a minimum amount of liquidity, funds entered these crises with higher levels of liquidity than previously. Most good MMF managers had anticipated the possible negative consequences of such events to a certain extent and had between 45% or 50% of weekly liquidity, higher than the levels required by regulation. All MMFs were able to reach redemption requirements, but they were confronted with stasis in the underlying short term markets, which made it very difficult to sell any assets.

Fund managers hold sufficient liquidity in normal times to manage inflows and outflows without having to sell assets, the industry speaker emphasized. That is the nature of the MMF product, and it is why 98% of underlying assets are held to maturity. MMF managers normally only sell assets if they want to go further down the yield curve, e.g. sell a short piece of paper and buy a longer one to benefit from a higher rate of interest. Otherwise, fund managers hold their store of liquidity to meet redemptions. This is what happened during both of the stress events of 2020 and 2022, for which MMFR fundamentally worked, showing that no substantial reform programme is needed.

Another industry speaker agreed that the MMFR framework had proven to be robust during the latest stress events. There were no MMF suspensions; there was no use of redemption gates; no liquidity fees were applied; no low volatility net asset value MMFs (LVNAV) breached their collar requirements[1]; and there was no need for direct interventions from central banks. The US regulatory framework governing MMFs did not prove to be as effective. In the EU there is a constructive discussion between the industry and the public authorities following the recent market events about possible targeted adjustments to MMFR that should be further considered.

A Central Bank official agreed that MMFR effectively tackles the main issues created by MMFs. However, there is a case for targeted improvements to ensure investor protection and mitigate unexpected stability shocks, such as those observed since MMFR was implemented in 2018. Some parts of MMFR are not useful, such as linking the level of weekly liquid assets to the consideration of redemption fees and gates. This causes potential cliff edges and incentivises investors to get out before they are caught by gates or liquidity fees. There are also problems with meeting redemptions, which led MMFs to sell assets which were meant to be held to maturity. All MMFs were able to meet their redemptions eventually, but only with a significant central banking intervention in the underlying short term markets. This means that there probably is a case for considering the functioning of the underlying short term paper market. Regulators should also consider implementing remedies that will enhance the MMFR operational framework and investor protection. This is also a global issue, for which an international alignment of frameworks and standards is needed, as well as cross border cooperation between regulators and supervisors to avoid unnecessary frictions.

2.2 Areas of improvement for MMFR: liquidity management tools (LMTs), MMF product categories and liquidity buffers

Several panellists emphasised that the delinking of the imposition of LMTs, such as gates and liquidity fees, to minimum liquidity requirements is a priority and should be tackled as soon as possible. An industry speaker observed that this delinking is essential in times of stress, but is also needed in a normal market environment.

A Central Bank official suggested that the MMF regulatory framework needs strengthening to consolidate the central role of MMFs in the European and global landscape. This must be done in a way that is well understood and well calibrated so that the framework works as expected and provides resilience in times of stress. Significant work has been done at the international level by the Financial Stability Board and IOSCO and at the European level by the ESRB and ESMA to identify the root causes of the issues experienced by MMFs and provide a menu of options. There is also a broad alignment between the main measures proposed at the global and the European levels.

The Central Bank official highlighted two types of measures likely to close out the present gaps in a practical and effective way. Firstly, it is very important for there to be widespread and effective availability of LMTs, on which there is a broad consensus, and appropriate guidance on how to use them. There should be no stigma to using LMTs either. The applicability of these tools to different kinds of funds remains to be fine-tuned, notably concerning swing pricing, which may not always be suitable. In addition practical guidance on the use of LMTs needs to be provided. The key element will be creating a framework that allows the use of these tools in normal times, so that the market stakeholders know how to use them, rather than restricting them to extreme situations. Additionally, solutions need to be found to mitigate the risks from LVNAVs, which is a more controversial issue. Many authorities are suggesting that there is a problem with amortised costs and that the stable element of these MMFs should be removed.

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

The Central Bank official suggested that strengthening weekly and daily liquidity requirements is a more important objective than reviewing MMF categories. Liquidity should be available for fund managers to use as necessary in a structured and calibrated way. This means having rules so that liquidity can be depleted in a proportionate way, when needed, with a floor, and rebuilt when conditions improve. It has been proposed that public debt buffers could potentially enhance MMF resilience, but there are different opinions on this subject that need to be further examined.

An industry representative emphasised that during times of stress all MMFs in the EU had significant redemptions, whether it was LVNAV, constant net asset value (CNAV) or variable net asset value (VNAV) MMFs. These different MMF categories should be retained because they correspond to different investor needs and performed as intended during the two major stress events of 2020 and 2022. Eliminating or significantly modifying these products in the legislation does not seem to be the right way forward, because the industry would then have to wait for another three or four years before the framework is stabilized with new product categories. This would hinder the capacity of the MMF sector to support the Capital Markets Union (CMU) and the banking sector at a time when additional low cost funding in multiple currencies is much needed to assist the real economy.

An official mentioned that the UK Financial Conduct Authority (FCA) has recently issued a consultation paper on MMFs covering similar areas to those mentioned by the panellists. A number of options are being considered by the FCA regarding MMFs, including minimum liquid assets and the removal of the ties between liquidity thresholds and the triggering of LMTs such as gates. It is also considering how to make buffers more usable, whether to pass on the costs of liquidity to investors and whether or not to remove the stable NAV element from LVNAV funds. The FCA has made clear that the UK is not in favour of reliance on sponsor support and does not intend to rely on capital buffers. The FCA's intention is to legislate in a way that is consistent with the approach taken at the global level. The ongoing UK public consultation reflects in many ways the report that was issued by the Financial Stability Board (FSB) in cooperation with IOSCO, which is also being considered in the EU.

2.3 Issues related to the short term funding markets underlying MMFs

The Chair observed that the short term markets, which are a large part of the assets in which MMFs invest, do not benefit from an effective market or market structure at present and are part of the liquidity issues that MMFs face. Short term papers are close to buy and hold assets and are extremely difficult to sell if a buyer comes under pressure.

An industry representative confirmed that one of the main lessons of the liquidity crises that MMFs have faced in recent years is the need to improve the short term funding markets. These issues were purely about liquidity and quite different from the credit crisis of 2008 09. Every single piece of paper that MMFs held paid on its due date, so there was no issue about bad assets. In normal times, these assets would be sellable into a good marketplace. The reason why MMFs wanted to sell assets was due to the improper linkage between liquidity levels and fees and gates. They were trying to ensure there was a 30% weekly liquidity level and a 10% daily liquidity level, as required. Improvements are needed in the short term paper market in terms of transparency and liquidity in order to avoid a state of stasis in the market in the future.

A second industry speaker agreed that the short term paper markets are the main issue underlying the liquidity problems associated with MMFs. While fully eliminating the kinds of market stresses that emerged at the outset of the Covid crisis is impossible, it is possible to enhance the structure of the short term paper market in order to make it more resilient in times of stress and to develop contingency plans. Central banks do not want to be lenders of first resort, which is understandable, but they should at least fix the limits beyond which they may need to act as lenders of last resort. There are several key issues to also address in the short term paper markets. First, there should be a focus on supply to ensure that paper is available with robust issuance. Banking regulations do not currently encourage short term issuance and there is at present a lack of government supply outside the US. Secondly, there needs to be the ability to make two way markets and intermediaries such as the global systemically important banks (G SIBs) have an important role to play in this regard for achieving sufficiently deep market trading. Thirdly, there is a need to enhance transparency. The ECB and other central banks in Europe do not publish issuance information in the same way as the Federal Reserve. In the US, there are weekly updates on commercial paper issuance, size, rates and ratings. Finally, if there is no appetite to issue more short term debt, it may be necessary to create a European equivalent to the Federal Reserve's overnight reverse repo programme to avoid direct intervention in the market.

A third industry speaker concurred that addressing the structure of underlying markets would help to mitigate the impact of future crises on the MMF market, although it is a challenging issue to tackle for industry participants, regulators and policymakers.

The Chair commented that aiming to enhance the supply of paper and market-making in short term paper markets are relevant objectives, but figuring out the first steps to take to improve the very weak structure of these markets is quite challenging.

3. Possible actions needed concerning open-ended funds (OEF)

Asked to comment on potential financial stability issues related to OEFs structured under the Alternative Investment Fund Managers Directive (AIFMD), an industry speaker stated that AIFMD has been a very strong regulatory framework for investment funds in Europe, ensuring the resilience of the broader OEF sector throughout recent stress events. The level of nervousness observed concerning MMFs during the Covid crisis in particular did not happen for OEFs. However, some areas of AIFMD could be improved when taking a practitioners' perspective. First, it is important to ensure that a wide variety of LMTs are available and that they are used in a consistent way across EU jurisdictions. The choice to use those tools should be left with investment managers and fund boards, because they are closest to the markets and they know about the nature of the holdings and liquidity profiles within their funds and are aware of the changes in investor sentiment. Investment managers are therefore best placed to make expedient decisions around the best tools to use at the best time. There is also a choice to be made about whether to develop regulatory technical standards regarding LMTs or issue guidance. The latter option seems preferable because it can allow an iterative process. Being too prescriptive on LMTs might compound stress in a stressful environment, whereas guidance can allow practitioners to react and learn because every crisis is somewhat different.

Invited to comment on whether guidance is the right approach to make further changes to AIFMD, an official was satisfied with the Commission's proposal to review the AIFMD and UCITS Directives. LMTs will help asset managers to deal with redemption pressures in stressed market conditions – of course provided that the tools are not only available, but in fact used when required. There are however additional action points to consider. Firstly, to further enhance financial stability risk monitoring, proper figures and statistics are needed for UCITS, which is not the case at present. Secondly, structural liquidity mismatches need to be addressed, especially in funds investing in inherently less liquid assets (e.g. real estate) while offering frequent redemption opportunities. Finally, while MMFs are resilient to monetary policy rate increases, which is something that is regularly tested in stress tests, this might not be true for all OEFs. The ESRB has recently published an update of its NBFI Risk Monitor indicating that a rise of 100 basis points of interest rates would result in bond fund losses of around 4% of NAV. The impact would however vary widely by fund – with up to 35% NAV losses for some. As the yield curve is moving rapidly, some market participants will win and others will lose.

The Chair emphasised that, whilst UCITS reporting is probably not justified solely in relation to securities regulation, it is needed to establish and monitor criteria that determine financial stability for the UCITS fund market. This is very important for the financial stability oversight of the marketplace, even if UCITS funds are generally safe. In addition, the size and the importance of the fund sector is now such that this type of reporting is essential for UCITS.