FUND LIQUIDITY ISSUES

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Addressing fund liquidity issues: the opportunity of a booming MMF industry

At the last panel discussion on Money Market Funds (MMFs) at Eurofi in Prague (September 2022), it was noted that monetary policy normalisation would have led to large inflows to MMFs, as this historical pattern was confirmed by persistent developments in the last decades. To the contrary, other types of investment funds would have been facing potential issues due to sudden bond repricing. It was also noted that this positive market outlook for MMFs represented an opportunity to fix some structural weaknesses of their regulation at a time when asset managers were strong and had resources to accommodate regulatory changes.

The first part of those conclusions (the increase in MMF assets) has materialised, to the point that one could speak of a MMF industry boom. For instance, after the LDI episode in October, MMFs in the United Kingdom received inflows from pension funds for around £50bn. Since the US regional banks showed important weaknesses, more than USD250bn have moved from bank deposits to MMFs in the United States in one single month. Compared to one year ago, US inflows have summed up to more than USD540bn. Also in Europe, MMFs had around EUR35bn inflows in March. Of course, on both shores of the Atlantic there has been also some reallocation from MMFs exposed to private debt to MMFs exposed to government bonds, possibly reflecting a desire to cut down indirect exposures to the banking sector.

The second part of last panel's conclusions (benefiting from favourable market conditions to achieve better MMF regulation) has unfortunately not materialised yet, despite of work at the FSB and in Europe at ESMA, the ESRB and the ECB. Yet, authorities are worried that an inflated MMF sector – still suffering of systematic first-mover advantages – might experience new tensions with a potential adverse systemic impact on the financial sector and the economy. On 21st March Verena Ross (ESMA) stressed the need of a regulatory review at the ALFI fund industry conference in Luxemburg. The latest Financial Policy Review of the Bank of England reiterated the request on 29th March and announced a forthcoming industry consultation. One day after, Secretary of the Treasury Janet Yellen abundantly referred to MMF systemic vulnerabilities and the need for a regulatory response in a speech at the National Association for Business Economics Conference in Washington.

This happens at a time when market analysts are interrogating themselves on the liquidity impact of MMFs for global liquidity conditions. For instance, they are discussing whether the increased use of the FED reverse repo facility by MMFs in the United States (around USD 70bn only in March) may or may not impact on the liquidity of the US banking sector, in particular for smaller banks. The impact of MMF inflows on global liquidity conditions seems to be less pronounced in Europe.

More generally, several episodes of market illiquidity have materialised during 2022H2 (energy price squeeze in August-September, LDIs in September-October). Recently, questions on liquidity conditions have been compounded by the flightiness of the bank deposit base after the runs at Silicon Valley Bank and Credit Suisse. Much has been written on the impact that FinTech may have on the speed of bank withdrawals. Also, the recent developments related to AT1 bonds are a reminder that market liquidity conditions can deteriorate suddenly. Finally, liquidity has also become an issue in some life insurance markets in Europe.

Turning back to the fund industry, structural liquidity mismatches which need to be addressed are also present in some corporate bond funds. In the European Union, progress has been made in the context of the AIFMD/UCITS review to enhance liquidity management provisions for all UCITS and AIFs with an improved access to liquidity management tools (LMTs) and an enhancement of reporting obligations. This legislation has entered the trialogue phase and should be concluded in this parliamentary term.

Besides liquidity, also credit risk is on the rise. Think, for instance, about Commercial Real Estate exposures of institutional investors, which are receiving more and more attention from a financial stability perspective. The jury is out on whether these CRE risks should be addressed horizontally through a single regulatory action impacting on financial sectors (banks, insurance, asset management, private equity, etc.) or whether it is more appropriate to review existing sectorial regulation through a coordinated reform. However, the perception of the need for action is increasing. For instance, the latest article "The growing role of investment funds in euro area real estate markets: risks and policy considerations" by Pierce Daly, Lennart Dekker, Seán O'Sullivan, Ellen Ryan and Michael Wedow, published in the ECB website on 1st April, includes an analysis of vulnerabilities of Real Estate Investment Funds (REIFS). Their message is aligned with the January 2023 recommendation of the ESRB on "Vulnerabilities in the commercial real estate sector in the European Economic Area."

More generally, the credit quality of bond fund holdings remains a concern, with bond fund holdings below investment grade rating amounting to approximately 40%.

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The illiquidity premium and financial stability

It is well understood that instruments that are hard to trade or just don't trade benefit from a premium, even if this is never the only influence on returns and pricing. If I am an asset manager trying to maximise returns for my clients, it is very tempting for me to invest in such assets. But if I offer an ability for investors to get their money back at short notice, I have just created a huge problem for myself : to attract customers, I have just added to the risks of my fund not functioning properly.

Normally the threat is manageable. In most investment funds, the amount of shares that are redeemed at any time is low. The outflow is often covered by the inflow of new investments. If it isn't, I will usually keep a small cash or near-cash buffer to deal with those situations. There is a bit of a disadvantage for investors in this, because the bigger the cash buffer the lower the overall return on the fund. If I keep a very large cash buffer, I could easily wipe out the illiquidity premium. If I am invested in equities and that cash buffer proves inadequate, I can easily go to the market. Equity trading is almost never all one way. There is almost always someone willing to invest, if the price is right. Consequently, I may be forced to sell at a time that harms the interests of the continuing investors, but I can sell.
However, there isn't much of an illiquidity premium in equities. I have to go elsewhere for that. So I go to bonds and similar assets. If I am an MMF manager I go from short term treasuries to bank CD and CP. To increase my client's returns I have now created a risk that I might not be able to return them their investment when they want it. And if I can get it back to them, I have created a risk that I will do so only at the cost of significantly damaging the investment of remaining investors.

Moreover, as monetary policy is tightened and interest rates rise, so does the liquidity premium, meaning that issue becomes more acute.
IOSCO and the FSB have been urging asset managers to design funds with this in mind, to develop contingency planning with this in mind and to get better and better at liquidity management with this in mind. Asset managers have responded. Contingency planning is getting better. Liquidity planning is getting better. But what is not getting better is fund design. Asset managers continue to offer daily dealing on funds designed to be invested in highly illiquid assets. It isn't credible. It threatens stability.

There are two things that need to be done: asset managers need to ensure that redeeming investors rather than continuing investors bear the full cost of leaving investment funds. Secondly where asset managers continue to design funds in this way, they should be subject to tighter regulatory regimes. There is more work to be done on this.

Contingency and liquidity planning are getting better, fund design is not.

This year IOSCO will produce guidance on swing pricing and related measures that investment funds can use to ensure that redeeming investors pay the full cost of redemptions in a period of stress. The FSB with IOSCO fully involved in the work will also revise its 2017 Recommendations to encourage a greater focus on those funds which have the least liquid assets. IOSCO will then reflect on additional steps it can take to encourage jurisdictions and asset managers to zone in on those funds which have the least liquid assets and which are most likely to amplify stress if they face a large wave of redemption demands. Of course, none of this is exhaustive in that we have seen recently that even the most liquid securities markets can be problematic in a period of stress. But the emphasis is correct.

There is also a third potential part of this package of measures. We often talk about the 'market' for CD, CP, corporate bonds and other alternative assets. Many of these assets have a secondary market in name only or an under-developed secondary market relying on clunky RFQ procedures and with little transparency. The problem can be hidden by the existence of ETFs invested in those assets which appear to resolve the price discovery process for rarely traded assets. But the truth remains: these asset markets are as far away from equity markets in terms of structure, liquidity and secondary trading as it is possible to be. That is why they 'benefit' from a liquidity premium! And yet we have made little progress on developing well structured secondary markets in these assets.

There are numerous interested parties telling us it can't be done. Perhaps not. But if it cannot be done, then the question we face is how tight the regulatory regime needs to be for daily dealing investment funds that continue to insist on searching out that illiquidity premium.

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Money market funds – the need for reform

Since the global financial crisis, when problems in the global financial sector led to a deep recession, policy makers have sought to ensure that the financial system can absorb not amplify shocks, supporting the economy in good times and bad.

Market-based finance (MBF) plays an important role in today's global financial system. Between the start of the global financial crisis and end-2021, MBF more than doubled in size, compared to banking sector growth of around 60%. MBF now accounts for around half the total assets making up the global financial system. It also plays an important role providing finance to the real economy. In 2021, MBF intermediated around half of all lending to UK businesses and since 2007, accounted for nearly all of the growth in lending to UK businesses.

Vulnerabilities in MBF can impact financial stability in a number of ways: directly through reduced provision of credit to households and businesses, through exposures to systemic institutions such as banks, or by amplifying volatility in markets and contributing to core market dysfunction, which can impact financing conditions in the real economy. Vulnerabilities in MBF can take a number of forms, including liquidity mismatches in money market funds (MMFs) and open-ended funds (OEFs) or under-preparedness for liquidity demands from margin calls or leveraged positions. This article is focused on one of these vulnerabilities: liquidity mismatch in MMFs.

The 'dash for cash' in March 2020 demonstrated the importance of ensuring that non-bank financial intermediation is resilient enough to manage liquidity risk in times of stress. MMFs came under severe strain, as investors sought access to cash. Confronted with severe redemption pressure, many MMFs struggled to maintain liquidity levels significantly above the 30% weekly liquid asset requirement and found their ability to generate additional liquidity, for example through asset sales, constrained. This increased the risk of suspension, and in turn the incentives for investors to redeem.

The quick and large-scale responses by central banks including the Fed, Bank of England and ECB, together with fiscal policy measures, restored market functioning. Without those extraordinary measures, the redemption pressure on MMFs may have continued, and some funds may have chosen to suspend redemptions. This could have led to companies failing to make business critical payments – with potentially wide repercussions across the global real economy and financial sector.

MMFs play a crucial role in the financial sector and real economy.

MMFs are subject to liquidity regulation brought in after the 2008 global financial crisis. However, the vulnerabilities exposed in March 2020 demonstrated that, despite this regulation, MMFs may not be sufficiently resilient to severe but plausible market stresses.

MMFs play a crucial role in the financial sector and real economy. During the September 2022 stress, some MMFs used by LDI funds saw outflows that were bigger than during the dash for cash. More recently, MMFs based in the US and Europe that invest in short-term US government debt have seen large inflows following the recent stress in the banking sector. These events highlight the interconnectedness of the financial system, and the important role that MMFs play in this system as a vehicle through which many other corporates and financial companies maintain their own resilience – be it cash management or a source of liquidity for margin payments or leveraged positions. For financial stability, it is therefore necessary that MMFs maintain sufficient resilience.

Robust international policy action has been taken: In 2021, the Financial Stability Board (FSB) published Policy Proposals to Enhance MMF Resilience to address the structural vulnerabilities and 'run risks' associated with MMFs.

FSB members agreed to assess and address the vulnerabilities that MMFs pose in their jurisdiction by utilising the framework and policy toolkit set out in the report, which includes measures to impose on redeeming investors the costs of their redemptions and reduce liquidity transformation. The FSB will review progress by members in adopting reforms to enhance MMF resilience this year, before undertaking a full effectiveness assessment in 2026.

Given the cross-border nature of MMFs, it is important that jurisdictions take steps to implement the agreed reforms. Until this policy work is complete and the policy responses implemented across different jurisdictions – the underlying vulnerabilities remain and could resurface in market stress. In particular, the sharp transition to higher interest rates and currently high volatility increases the likelihood that vulnerabilities crystallise and pose risks to financial stability.

In the UK, the Bank and the Financial Conduct Authority have issued a Discussion Paper seeking views on how to strengthen the resilience of MMFs. Feedback received will inform a Consultation Paper to be published later in 2023.

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MMFs: a cornerstone of market liquidity in times of stress

Money Market Funds play a fundamental role in underpinning market stability. The movement of cash throughout the financial system on a day or intraday basis has become more important in recent years due to, amongst other things, the heightened importance of margining to safeguard financial stability. At the same time, many corporates and financial entities find it difficult to place non-term deposits with banks due to limited balance sheet capacity and capital constraints. MMFs are now one of the most important tools for many investors to hold liquidity and move cash on an intraday basis.

In recent years, episodes of market stress resulted in notable flows into and from MMFs, underscoring their resilience. There is clear evidence of the critical role MMFs play in continuously providing liquidity to investors who need it during times of market stress. During the recent episodes of bank stress, global MMFs have drawn significant inflows from investors seeking protection through diversification.

Market volatility has provided a real test of the existing EU and US regulatory regimes for MMFs and it is important to reflect upon whether and where improvements may be warranted to further enhance the resilience of MMFs to these types of market dislocations. However, it is equally important to ensure that reforms do not undermine the ability of MMFs to play their cornerstone role in providing liquidity management.

Following the COVID-19 related market disruptions in March 2020, policymakers around the world have been drawing lessons from the market turmoil to improve the resilience of various product and market structures. MMFs were one of the first areas for focus for global, US and European policymakers since March 2020 offered important lessons to improve the resilience of MMFs in times of market stress, many of which are widely agreed upon by policymakers and the market alike. They include: 1) reducing the threshold effect related to breaches of Weekly Liquid Asset (WLA) buffers; 2)ensuring MMFs have a robust and transparent framework for the use of liquidity management tools (LMTs); and 3) improving the frequency and quality of data which is reported by MMFs to supervisors and to the market. In the EU, points 1) and 2) will almost certainly be addressed through the Level 2 work on the UCITS/ AIFMD framework which is set to be agreed soon.

Outflows from MMFs are often a sign of their resilience, not a potential vulnerability.

The more contentious debate is around the future of the Low-Volatility NAV (LVNAV) framework, a key introduction of the EU Money Market Fund Regulation (MMFR) framework, and a means of liquidity management that many European investors find enormously valuable. While some commentators have asserted that LVNAV funds have an inherent 'cliff edge' risk in the so-called 20bps pricing 'collar', we believe evidence for this is lacking. Analysis of individual fund flows and price movements during the market volatility of March 2020, and the UK gilt market turmoil in October 2022, shows that there is no investor redemption pattern correlated with NAV deviations in LVNAV funds.

What these events did show, however, is that it is possible for an LVNAV fund to cross the 20bps threshold. This is not, in and of itself, a cause for concern – it is a deliberate feature of LVNAV MMFs. They also highlighted the lack of clarity as to how funds would handle such an operating event: would they be able to continue providing intraday liquidity, or would they need to shut the fund for a period to build the capability to deal at a variable price? We believe regulators should ask LVNAV managers to clearly articulate to investors how (and how frequently) they would be able to process redemptions if required to deal at a price rounded to 4 decimal places rather than 2.

Finally, the most important point in the broader MMF resilience debate is often lost in focusing solely on funds themselves. MMFs are only one part - albeit an important one - of the overall market liquidity landscape. Alleviating structural pinch points in the financial system generally – for example the potentially procyclical impacts of margin requirements in time of volatility and stress – will be the most effective way to ensure the resilience of MMFs. There are practical ways to reduce redemption pressures on MMFs caused by investors' margin requirements and it is today operationally possible to transfer shares of MMFs directly to facilitate margin payments, although the regulatory framework must be adjusted to allow for this.

MMFs are a critical tool for many investors meeting a variety of cash and liquidity management needs. Targeted MMF reforms can enhance their resilience, and reforms to alleviate ecosystem pinch points can improve the functioning of the short-term funding markets.

It's important that any changes maintain the fundamental attractiveness of MMFs to the range of users who rely on them today, and thus allow them to continue fulfilling the important role they play in the provision of liquidity during both normal and stressed market conditions.

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From March 2020 to March 2023: lessons on market liquidity

2023 will be an important year for the future financial regulatory agenda. On the back of rising inflation and as a result rising interest rates, regulators around the world are looking for potential risks in the system, including in the non-banking sector. However, as recent events in the banking sector demonstrate, it is hard to forecast the source of the next instability in the financial system. That is why it is helpful to remind ourselves of what has proved resilient in past stress events and what works well today.

Let's start with Money Market Funds.

The events of March 2020 are a regular subject of debate when it comes to assess the resiliency of MMFs. It was undoubtedly a serious and real-life stress test for the whole financial ecosystem. The trigger was an exceptional and unprecedented demand for liquidity, driven by the shutdown of the economic activity during the COVID pandemic and not by market concerns on the underlying quality of investments in MMFs.

In March 2023, we have witnessed the reverse happening with MMFs inflows recording an all-time high. According to data collected by the Investment Company Institute (ICI), total money market fund assets increased by $117.41 billion to $5.13 trillion for the week ended on March 22, driven almost exclusively by government funds.

These events would seem to suggest that when considering possible reforms, the role and importance of MMFs for the overall financial ecosystem and wider economy need to be taken into account and preserved. Reforms should therefore allow MMFs to make use of their available liquidity during times of market stress, by de-linking MMF minimum liquidity requirements, namely the 30% Weekly Liquid Asset (WLA) threshold, and the potential imposition of liquidity fees and redemption gates.

While fully eliminating market stresses such as March 2020 or March 2023 is impossible, it is possible to enhance the structure of the short-term funding market and of fixed-income markets more broadly. This is another area where regulatory reform can help to mitigate the impact of the next crisis by improving the market structure of CP and CD and by ensuring sufficient secondary market liquidity via discretionary market-making activities. In the EU, the European Commission will in the coming weeks publish an important report taking stock of the MMF Regulation, a good opportunity to re-start the dialogue with the industry on these ideas.

The value of ETFs for end investors should remain at the centre of the legislative agenda to complete the CMU.

Open-ended funds are the second item on the list of regulatory initiatives for this year.

Regulatory concerns in the case of open-ended funds originate from the understandable need of authorities to have comprehensive visibility of the financial system, filling any data gaps on liquidity risks and use of leverage. Moreover, regulators are concerned that these vulnerabilities, through channels of contagion, could amplify shocks to the whole financial system. However, open-ended funds are just one part, and by far the most regulated, of what is commonly referred to as "shadow banking" or Non-bank Financial Intermediation, and despite the stress that stock and bond markets have experienced over the last year, asset managers have, in most cases, managed to deal effectively with redemptions.

More generally, as the recent events in the banking sector demonstrate, liquidity mismatches are not limited to open-ended funds. Perhaps regulators should also be looking more carefully at the supply of liquidity in corporate and government bond markets. There are currently limited alternative sources of liquidity, as well as challenges to improving market-making especially by banks, and as a consequence these markets when under intense stress may be unable to absorb sudden increases in selling. Some ideas for reform to domestic government and corporate bond markets are included in the latest FSB report in enhancing the resilience of non-bank financial intermediation and should not be lost in the policy discussion.

Encouragingly, in the EU an important regulatory reform is already underway with the review of the AIFMD. The proposal, which is close to a final agreement, will reinforce reporting for UCITS funds and ensure the development of a strong EU framework for the design and use of LMTs, whose activation should nonetheless remain with investment managers and fund boards.

Finally, a positive actor that is easily forgotten is ETFs. ETFs have long offered investors value as liquidity and price discovery tools during crises. This latest banking crisis serves as another reminder of the additive liquidity created by ETFs and of the reasons why investors gravitate toward ETFs in times of market stress. Whilst the EU progresses in the completion of its Capital Markets Union, the value of ETFs for retail and professional investors should remain at the centre of the legislative agenda.

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Open-ended funds need both well-functioning markets and well-adapted regulations

While the Silicon Valley Bank and Credit Suisse collapses are negative market shocks and add to an already uncertain backdrop, they seem to pertain more to different idiosyncratic events than constituting – by themselves- a threat to financial stability. However, these recent events observed in the banking sector are a reminder that financial shocks can appear under multiple shapes. They also underline the need to closely monitor non-systemically important banks along with some other non-banking financial institutions.

It is then legitimate for national, EU and international financial authorities to explore the different options to enhance the regulatory and supervisory framework built to ensure financial stability and limit any spillover effect when crisis happen.

And indeed, since the great financial crisis, the banking regulation has been considerably reformed, while the fund management sector has been also substantially reinforced. As an example, the European MMFR (Money market fund regulation), adopted in 2017, enabled MMFs to enter the Covid19 crisis in a resilient and reliable condition. Indeed, back in March 2020, both real economy and financial system were facing the effects of the lockdowns imposed in a number of countries, MMFs recorded large outflows without any incident.

Moreover, not only could MMFs pay the redemption demands but very soon their users massively came back. This could happen because MMFs were not the cause of this major market liquidity crisis but rather revealed it. In this respect, we can only subscribe to the Financial Stability Board (FSB) assertion that "MMF reforms by themselves will not likely solve the structural fragilities of STFMs [short-term funding markets]"[1].

More generally, open ended funds (OEFs) have been put under high scrutiny for some years, as some regulators point out the need to address "liquidity mismatch" issues, where a discrepancy is supposed to lie between the timeframe of a fund's liability (mostly daily) and the time needed to liquidate its assets, sometimes much longer than days, especially during market stress. Such an assessment should be challenged, by reminding that OEFs, including MMFs, act as intermediaries between risk and performance takers, investors, and risk and performance providers, financial markets. Contrary to banks, that systematically perform transformation, OEFs balance sheets involve investors who bear the economic risks of the assets.

LMTs are fit for purpose for a fund to comply with the fair treatment it owes to its shareholders.

In this context, though most of the time their status of collective schemes allows for a pooling of the liquidity risk, OEFs may need to activate tools like swing-pricing or gates where a market liquidity deterioration, combined with unbalanced flows, require to do so. Such liquidity management tools (LMTs) are perfectly fit for purpose in order, for a fund, to comply with the fiduciary duties and fair treatment it owes to its shareholders. By limiting, or raising the cost to access liquidity, LMTs allow fund managers to reflect fairly to investors the market conditions under which inflows and outflows are dealt with.

In this perspective, we commend the recent developments of the EU Capital Markets Union action plan where both AIFM and UCITS Directives are about to be amended to include measures such as the mandatory availability of LMTs for OEFs. Such a change in the funds' regulation framework will undoubtedly enhance the resilience of both AIFs and UCITS funds during market stress, thus providing more financial stability.

Moreover, the probable introduction of a consolidated tape under the currently discussed MiFIR review will help enhance markets liquidity and transparency. As investment funds are products that require well-adapted regulation and well-functioning markets, such positive achievements are more than welcome.

Conversely, some of the measures currently contemplated could not only miss their goals but also undermine investment funds' attractiveness. These measures, meant to tackle the "liquidity mismatch", vary from requiring minimum liquid asset holdings to imposing longer notice periods or less frequent dealing for funds investing in "less liquid assets". Such policy options, some of them being clearly inspired by banking regulations, are not fit for purposes and would raise a series of structural and operational issues if adopted in investment funds' regulations: unworkability, cliff effects, non-adapted definitions and other unexpected side effects.

Regulation should rather focus on reinforcing the process by which end investors will be better informed about the liquidity risks they take when investing in a fund while the funds themselves will be better equipped to effectively cope with market liquidity shocks. Giving time for these changes to be implemented - and their impact to be assessed - is key to enhance financial stability while preserving EU-domiciled funds competitiveness.

[1] FSB, Policy Proposals to Enhance Money Market Fund Resilience, June 2021

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Policymakers rightly consider measures to improve short term funding markets

Short Term Funding Markets (STFMs) comprise mainly of certificates of deposit (CD) and commercial paper (CP) issued by financial and corporate entities to finance the real economy. In the EU, STFMs are the CMU's entry point. Market participants typically buy primary issuance and hold securities until maturity. This does not mean that STFMs are intrinsically illiquid. It is only in stressed times that participants may need a vibrant secondary market. In March 2020, as global investors sought liquidity as governments around the world shuttered their economies, STFMs froze when they were most needed.

Increasing liquidity and transparency must be addressed as part of any STFM improvement, as no one type of market participant was responsible for the structural failures of the STFM. The question to answer is: how do we organise STFMs so that their secondary markets remain fully functional in times of stress? Current workstreams undertaken by the Financial Stability Board and IOSCO, rooted in a factual analysis of why STFMs froze in March 2020, must be completed and we urge the FSB and IOSCO to recommend policy changes focused on transparency, depth and liquidity.

Large parts of the European CP and CD markets lack transparency. National regulators can only track issuance in their own markets: e.g., the Banque de France provide data on the French NEU CP market; the ECB on Short-term European Paper, and the Bank of England on the sterling CP market. While there are some commercial data providers, overall market participants lack an overview and struggle to ascertain STFM size and composition. Increased and central information on primary issuance for both investors and regulators is needed. More transparency on trades in both primary and secondary markets would also lead to more accurate pricing.

Policymakers express concern that STFMs have few market participants. Deeper STFMS, with many more and diversified participants, would be less vulnerable to shocks. Instead of looking only at those few market participants that need secondary trading in time of stress, policymakers should develop measures that will make STFMs more attractive in all circumstances. An urgent fix is needed to make STFMs fit for the 21st century.

We urge the FSB and IOSCO to recommend policy changes focused on transparency, depth and liquidity.

Ironically, it is more difficult for a professional investor to buy a CD or CP issued by a fully regulated EU bank than for a private citizen to buy a fraction of Bitcoin on an unregulated platform. Moving away from OTC trading, where buyers are normally limited to the issuer and selling broker and fostering the use of electronic all-to-all platforms, would make STFMs more attractive and competitive. Market participants and industry bodies must work with global policy makers in forming workable and practical suggestions for improving the functioning of global STFMs.

Deeper, more automated, less fragmented, more transparent STFMs will be more liquid. Central banks should play a key role in making STFMs more liquid, especially in time of stress. A standing repo facility whereby banks – i.e., entities that are fully regulated and supervised by the central bank - could obtain short term loans to fund their short-term holdings is key and should be established. Such facility could be limited to high-quality short-term ("HQST") assets as defined in bank prudential regulation. If participating banks could repo the HQST assets, even in stressed periods, banks would be more willing to buy them in times of stress, alleviating pressure in STFMs.

This would quickly improve liquidity in the underlying short term markets during periods of stress and be a market-based solution under the full supervision of the central banks. This would not be a bail-out. This would be a market mechanism by which central banks organise the liquidity through short-term, and consequently longer-term, financial markets. Ensuring liquidity of the financial system is surely the function of central banks in charge of financial stability. Better functioning STFMs would complement central banks' monetary policy. More liquid STFMs would be a win (sell side) - win (buy side) - win (central banks and policymakers) game.

In conclusion, central banks and global securities markets regulators should first address a root cause of financial contagion in times of crisis – a widespread and sharp drop in liquidity across markets, particularly in the STFMs that are vital to the functioning of the capital markets. We cannot emphasise enough the importance of improving STFMs and urge the FSB and IOSCO to continue to consider the actions necessary to improve STFMs.