Fund liquidity issues

Introduction

The Chair referred to potential developments in the money market fund (MMF) market discussed at the Eurofi September 2022 event in Prague. The fact that monetary policy normalisation would lead to large inflows into MMFs, representing an opportunity to fix some structural weaknesses of their regulation at a time when the position of asset managers is stronger was discussed. Large inflows in the hundreds of billions of $ into MMFs have happened in the US and UK. In Europe, the net position of MMFs has not changed that much, but there have been important shifts among the categories of funds. A review of the MMF regulation was not launched in the EU, despite assessments and recommendations made at the FSB, ESMA, ESRB and ECB levels.

At the event in Prague it was also suggested that other types of open ended funds (OEFs) would be facing potential liquidity issues e.g. due to sudden bond repricing. Several episodes of market illiquidity have materialised during H2 2022, such as the energy price squeeze in August and September and liability driven investments issues (LDIs) in September and October. Liquidity questions have recently been compounded by the flightiness of the bank deposit base observed during the runs at Silicon Valley Bank (SVB) and Credit Suisse. In the fund industry, structural liquidity mismatches have also been evidenced in some corporate bond funds.

In terms of regulation, progress has been made in Europe with the reviews of the AIFMD and UCITS directives that include inter alia measures to enhance liquidity management provisions with an improved access of funds to liquidity management tools (LMT) and an enhancement of reporting obligations. The legislation has entered the trialogue phase and should be concluded in the current parliamentary term.

1. Money Market Funds (MMFs)

1.1 Recent market trends and related impacts

An industry representative confirmed that although significant inflows into MMFs have been seen in the US, they have been modest and muted in Europe. Since April 2022, which was the peak of bank deposits during the pandemic, reaching around $18 trillion, roughly $900 billion of US deposits have left banks, and $650 billion of these have flowed into MMFs since June or July. In terms of proportions, bank deposits grew by 35% since the start of the pandemic and those outflows represented around 5%, which is limited. Some investors have rotated out of bank deposits and into MMFs, as well as exchange-traded funds (ETFs) and others have moved money to global systemically important banks (G-SIBs). The money has largely flowed into US Treasury MMFs, which have access to the reverse repo programme, introduced in 2013 by the Federal Reserve to bolster the credibility of its policy at the front end. That helps put a floor under the Fed rate by absorbing the excess cash that banks cannot absorb on a collateralised basis. There has been no issue for MMFs in terms of being able to invest that money.

Concerns have also been heard about possible substantial outflows from MMFs and how they could be handled. The industry speaker observed that MMFs, unlike other OEFs that meet redemptions by selling a slice of their portfolios, meet redemptions by cash on hand. Treasury MMFs currently have 60% of the cash available on overnight and their weighted average maturity is just 16 days, so there is little concern about whether they would be able to meet future redemptions.

A second industry representative explained that during the last eight months there has been an interest rate increase of 350 basis points in the Eurozone, which is massive, but European asset managers have not seen major movement in terms of inflows into euro-denominated MMFs, unlike the US. These amounted to approximately €50 billion, which is not massive. In terms of fund categories, low volatility NAV (LVNAV) MMFs were created following the implementation of the Money Market Funds Regulation (MMFR). There was a slight decline in US dollar LVNAV of approximately €30 billion over the last few months, while the US dollar public debt constant NAV (CNAV) MMFs recorded the same proportion of inflows, which was not a major shift.

In the next three to six months a slightly positive trend is expected to continue in terms of inflows, the industry speaker believed, because MMFs are low-risk vehicles and are offering an improved remuneration. Monetary policy will continue to impact the MMF sector in the coming months. The ECB has been lagging behind some other central banks in terms of interest-rate rises, so the anticipation is even more attractiveness of euro-denominated MMFs in the coming months, but not to the same extent as what happened in the US market. With a continued tightening of monetary policy there could also be opposite trends, with a trade-off between having the money in a bank savings account and an MMF. French inflation figures recently came out for example and they are not good, so the expectation is that tightening will continue. The remuneration of bank commercial paper (CP) and bank savings accounts is expected to increase.

The Chair asked whether in the euro segment there are significant transfers from MMFs exposed to banks towards MMFs exposed to sovereigns. An industry representative stated that their company sees that an overwhelming proportion of MMFs are invested in

private sector issuers, including banks. Their company has not experienced any outflows in the euro-denominated money market fund sector of that nature. A second industry representative added that their company is the sole provider of government liquidity euro-denominated MMFs. Some inflows have been seen in those funds, but it is up to €1 billion, which is not a significant risk to the European banking system.

A regulator considered that the current flows are rational. When rates started to increase following a long period of expansive monetary policy, there was an unusually high proportion of deposits in the banking system accumulated following the pandemic and also because of the lack of alternative investments. These deposits were waiting to be invested in a better way, for example through short-term instruments like MMFs. At the same time, most banks are currently still attempting to maximise their interest margin by keeping remuneration on deposits and savings accounts low, which provides additional incentives to seek yield elsewhere.

There is also the objective for uninsured depositors of diversifying counterparty risk, the regulator observed. Recent events in the banking sector have brought that risk back to the forefront. These evolutions may put banks that are excessively dependent on deposits in a difficult position, but some of those flows may flow back directly to the banking system depending on how the market evolves, because a significant part of inflows into MMFs go towards non-government-oriented MMFs which invest heavily into financial sector issuers. A part of these inflows into MMFs is therefore not lost funding for the banking system, but the flows are invested in a more diversified way from a client perspective. That is healthier for the client, and it may also be healthier for the banks, because to some extent it takes some of the liquidity risk away from the bank's balance sheet, creating positive market dynamics.

An official explained that during the September 2022 stress in the UK LDI market[1] some MMFs experienced very significant outflows, as market participants drew down funds in MMFs to meet margin calls. Some MMFs came close to their LVNAV collars, a breach of which would lead to a conversion into VNAV funds. Some MMFs had larger outflows than had been seen during the March 2020 'dash-for-cash', but there was more liquidity in the sector so it proved to be more resilient to outflows than in the past. As the LDI sector built its resilience up the money flowed back into the MMF sector. The cash buffers that the LDI funds built up were deposited in MMFs; assets under management (AUM) of MMFs rose by £80 billion over three weeks, which is significant for the sterling market, half of which happened in three days.

1.2 The importance of considering the specificities of MMF products and markets in policy initiatives

A regulator observed that the MMF market can evolve positively in the future as long as MMFs are not regulated as bank deposits. When assessing how to reduce systemic spill-over risks from the MMF sector, the question as to whether MMFs should be treated more as an investment-like or a bank-like product is regularly raised in the regulatory community. Considering that MMFs are a bank-like product is a dangerous option, because the implication is that they have the same liquidity characteristics and therefore need to be regulated in the same way, needing to create lenders of last resort for MMFs as part of the system, which does not seem appropriate. MMFs are investments; therefore any features of these funds that mimic deposits do not conceptually have a place in that market. All funds are as liquid as the assets in which they are invested. Reducing the risk of a demand-side run on the fund by eliminating first-mover advantage and by making sure that fund managers have the right tools and marketing practices in place and adequate communication channels with supervisors is critical to making sure that MMFs do not become systemic risk amplifiers.

An official agreed that not treating MMFs like deposits in regulation is important. Policy perspective concerning MMFs has been ambivalent in the past, sometimes proposing to treat them as deposits in certain circumstances and sometimes to regulate them as investment funds. Greater clarity would be helpful that they are not sufficiently like deposits.to be regulated by analogy with deposits. It is also important take the specificities of different MMF markets into account and avoiding a one-size-fits-all regulatory approach across the globe. Balance needs to be found between providing top-down guidance at the global level via FSB and IOSCO recommendations, and allowing jurisdictions to take into account the specificities of their market in the reforms proposed. That is the way IOSCO and the FSB addressed these issues in 2021. A set of options were proposed and jurisdictions were asked to analyse how these reforms could be best implemented, taking into account their local situation. In 2023 IOSCO will conduct a thematic review of regulatory initiatives taken in the MMF area.

Ireland and France for example both have large MMF sectors, which are different in their structure and behave very differently. There are also significant differences between the EU and the US when considering the recent flows observed in the US and EU MMF markets, the official explained. There are moreover differences in the way that jurisdictions have responded to stress events and in the regulatory frameworks that were subsequently

1. During the liability driven investment (LDI) episode in September 2022, the UK market saw very sharp, unprecedented moves in government gilt of 170 basis points in three days. That put LDI funds, which defined benefit pension schemes use to manage their liabilities in a leveraged way, under stress. The risk was that some of those funds may have to suspend redemptions, which would then have had knock-on effects in the government bond market. Very rapid rises were seen in mortgage rates and a withdrawal of mortgage products in the UK. 1,000 products disappeared from the market during that time, so it had potential real-economy implications. The Bank of England undertook a time-limited intervention to give the LDI funds time to recapitalise. It was a timing issue and a liquidity challenge, rather than a solvency issue. They needed time to get liquidity from the defined-benefit pension schemes that invested in them. The Bank of England conducted a two-week operation to intervene in the market, LDI funds recapitalised themselves, and the Bank of England exited the market and sold all of the government bonds that it had bought.

created, which condition the options for future initiatives to a certain extent if jurisdictions do not want to fundamentally change their framework.

An industry representative agreed that on the policy side there needs to be a clear distinction between banks and MMFs and that the application to funds of rules that are inspired by banking regulation should be avoided. Banking is about identifying profitable assets and then funding them through deposits, which is the opposite of MMFs that take in inflows and invest them in suitable assets. This difference needs to be reflected in regulation. Moreover the current banking stress in the US is fairly idiosyncratic and should not lead to proposing banking-type measures for MMFs such as an LCR (liquidity coverage ratio) for MMFs.

A second industry representative further explained that banks take deposits, which are a debt obligation, and invest them long. Banks are leveraged and have liabilities and liquidity mismatches. Investments in MMFs are an equity investment and they are loss-absorbing. Liquidity mismatch risk is limited because the redemptions are being paid out of cash. That is the importance of the 10% or 30% cash limit. The speaker also concurred with the comments made about differences between fund markets. For example, the US and EU MMF markets are very different, with different types and setups of institutional and retail funds, different investment strategies and different client behaviours. There are also differences in how interest rates are evolving and the implications this may have for MMFs.

An official noted that the UK authorities are working on the specific issues posed by MMFs. In 2022 the UK authorities published a discussion paper seeking views on how to strengthen the resilience of MMFs, and will publish a consultation paper later in 2023 based on the feedback received with policy proposals tailored for MMFs. The first question the consultation paper is attempting to address is the level of daily and weekly liquidity that MMFs need to maintain in order to be able to withstand severe but plausible redemption stresses. The levels of liquidity in the sector are very high at the moment, but they go beyond regulatory requirements. The second question is how to ensure the usability of those liquidity ratios. One of the issues observed with the March 2020 outflows was that when some MMFs reached liquidity levels of 30%, gating had to be considered, which then triggered the risk of further investor redemptions. The third question is how to address the risks posed by LVNAV funds. Those risks include the risk of a fund having to convert to variable NAV (VNAV) in stress, which might impact confidence in the market. Some investors prefer to be invested in LVNAVs for accounting reasons, so a potential conversion and possible exit from these funds raises issues that need to be appropriately handled. The costs and benefits of the possible measures envisaged also need considering, because there is not unlimited depth in government bond markets or in bank CP markets. More liquidity being required to handle MMF issues may therefore affect market dynamics.

1.3 Issues posed by the increasing speed and magnitude of flows

An official observed that due to the interconnectedness in the financial system and the essential role that MMFs play in the financial system as sources of liquidity and as cash management vehicles for corporates and financial institutions (e.g. to meet margin calls and maintain buffers) it is important that MMFs maintain sufficient resilience. There is also a strong cross-jurisdictional dimension to the MMF market with e.g. many dollar and sterling MMFs based in the EU. That is why it is important to implement the global FSB recommendations dealing with the vulnerabilities and run risks associated with MMFs and also to maintain international cooperation in this space. The FSB will review progress by members in adopting reforms to enhance MMF resilience this year, before undertaking a full effectiveness assessment in 2026.

A second official suggested that an important issue to tackle from an international and European perspective is how quickly corporate and financial institution holdings in MMFs move around, at what scale, and the impacts that has on the MMF market. In this regard, it might be helpful to consider the discussions happening in the banking sector related to the liquidity coverage ratio (LCR) around the fluidity of corporate deposits. There is also the need to anticipate better extreme scenarios. That sufficient buffers are in place in terms of overnight liquidity, as mentioned by a previous speaker, is reassuring but there could be a stress scenario where all the recent inflows into MMFs move in the same direction, e.g. out of treasury MMFs into bank-focused MMFs in search for higher return, which could lead to higher stress than during previous events if funds invested in bank-focused MMFs then left the MMF sector together. Care should be taken not to jump to conclusions from previous stress events.

The Chair noted there are also competing movements between bank deposits and funds with liquidity flowing from one to the other at high speed.

An industry representative stated that the competition between bank deposits and MMFs is not new, but what has changed is the volume and the speed of the flows. There have been significant inflows into government MMFs in the last few months that are expected to reverse towards MMFs invested in banking sector issuers at some time. A key underlying factor is technology that allows liquidity movements to happen very quickly and where social media also play an increasing role. This is a concern both for financial institutions and regulators that needs addressing in the future policy agenda. The events that happened at SVB were extraordinarily fast. The 2008 crisis happened in two or three days, not three hours.

An industry representative agreed that the speed of outflows is an issue that needs to be looked at, even though bank robustness has increased. Concerning MMFs, a key point to bear in mind is that outflows are actually a sign of resiliency, because they are contributing to meet real economy needs. In March 2020, when primary and secondary markets were closed, the outflows from MMFs were helping corporates

pay salaries and pensions, or helping pension funds provide collateral margin to central counterparties (CCPs). Discussion is needed about the ability of using MMF units as collateral, because the present situation increases the potential volume of flows happening. Referring to a previous comment about the risk of MMFs all behaving in the same way, the industry speaker stated that was unlikely, because of the differences across MMF markets previously mentioned.

An industry representative observed that the March 2020 crisis showed that the EU MMFR regulation that entered into application in 2018 proved to be quite effective in handling the risks from outflows. In March 2020 corporates needed to release money held in MMFs to pay salaries because of lockdown, and the instruments in place such as VNAV and swing pricing made that possible.

2. Open Ended Funds (OEFs)

An official noted that significant progress has been made in the policy approach to OEFs at the international level, notably in relation to crisis management and liquidity management, although some issues remain to be tackled as part of the non-banking financial institution (NBFI) work programme of IOSCO and the FSB. One major area where progress has been insufficient so far is illiquid assets and overnight liquidity, which is still a serious problem in relation to investment funds. This is mainly an issue of fund design. The question is whether asset managers should continue designing funds that invest in illiquid assets and are offering overnight liquidity and, if this is the case, what measures are needed to make this situation more stable. This issue was tackled by the ESRB in 2018 and it was recommended to implement a mechanism for the classification of assets, so that a more intense oversight of funds that have the least liquid assets can be put in place in order to check that they are adequately designed and managed. Work is also underway at FSB level in this area. A caveat however is the potential difficulty of classifying the liquidity of assets.

The official added that jurisdictions need to ensure that OEFs have access to a sufficiently broad range of price based and quantity based LMT options. We need to observe market developments in future to see if, when they have only one LMT, or only one of each sort, this creates a cliff-edge effect because in a stressed situation market participants will anticipate whether the fund is about to trigger the particular LMT available and they may act and run in advance of that. IOSCO's forthcoming guidelines as to how to implement swing pricing in particular will be helpful as this is an important price-based LMT.

A second official stated that the UK authorities are working on these issues as well, in close cooperation with IOSCO and the FSB, and that inter-standard-setter coordination is very effective in this area. In 2017 the FSB recommended that the redemption policies of funds need to be aligned with the liquidity of the underlying assets. When assets are structurally very liquid or illiquid, this is easy to implement. The difficulty is for assets for which liquidity fluctuates according to market conditions. Ensuring that adequate LMTs are in place in order to impose on redeeming investors the costs of their redemptions and reduce the risks associated with liquidity transformation would be important. There were also other recommendations on stress-testing and reporting. The objective is to design rules that may be implemented in a consistent way across funds, but without creating a straitjacket. In a UK survey, some funds appeared to be overestimating the liquidity of their assets. Most funds surveyed used LMTs such as swing pricing, but the differences in approach were very marked and the market impacts of swing pricing actions were not always sufficiently considered, showing the need to enhance consistency in the way liquidity management issues are approached by OEFs.

A regulator observed that the issues posed by OEFs and MMFs are not that different, except that with OEFs there is no risk of confusion with bank deposits and liquidity mismatch can be more acute. There has been much progress on the crisis management tools to be used during a crisis or ex post, but more needs to be done about the ex ante reduction of risk in order to avoid a rush for the exits because there is a proven liquidity mismatch. The proposals made at the global level around classifying assets look pragmatic and wise but may be challenging to implement, because there is a continuum of liquidity across assets and sophisticated techniques are also being used by funds to enhance liquidity. For example some distributors are selling funds to investors, including retail ones, on the basis of largely overstated liquidity. That raises suitability and investor protection issues, even if LMTs are in place. A question is whether investors are aware of their liquidity needs and can cope with the sudden imposition of a gate that they were not aware of.

An industry representative believed that a flexible approach is needed regarding fund regulation. From a liquidity perspective ETFs are different from other types of funds for example. Swing pricing is also challenging to implement in certain markets e.g. in the US because the current market structure makes implementation difficult for investors and intermediaries, notably with time differences and hard time limits imposed. A further issue for asset managers is coping with a broad range of policy objectives at the same time including financial stability, investor protection and fiduciary duty and understanding how they may be translated operationally. Taking care of investors is part of day-to-day operations, but it is challenging for fund managers to understand how they can contribute to the financial stability of global markets in their daily work. Regulators could lay out their priorities in more practical terms and better explain how to translate them into areas of improvement that market participant can work on.

A second industry representative stated that in the EU the reform regarding OEFs is currently being negotiated with on-going trialogues on the AIFMD and UCITS reviews. One of the key proposals is making sure that there is an equivalent access to LMTs across EU member states and a variety of instruments available. Harmonised rules around how these instruments should be triggered and used have also been established.

The final decision should remain in the hands of the asset manager, not the authority, and there should be clear, harmonised conditions for implementing these tools. This is vital to avoid any first mover advantage effect. The industry speaker also noted that possible asset classification measures require promoting greater transparency in the market about the instruments that the client base invests in. This information is held by the distributors but is rarely communicated to the asset managers, making it difficult for them to adapt their approach of the market.

A third industry representative agreed with previous comments about the importance of aligning fund redemption conditions with the liquidity of assets. Addressing issues related to illiquid assets or assets where dealing frequency is limited is the priority. OEFs investing in inherently illiquid assets like real estate seems inappropriate and longer notice periods are needed when daily dealing systems are in place e.g. for asset-backed securities (ABS). In addition, the perception of liquidity can be incorrect if it is not based on market data showing how different asset classes behave in normal and stressed times. Emerging-market debt or high-yield debt is sometimes considered as illiquid, but in March 2020 data shows that there were far more transactions in these instruments as a percentage of outstanding volumes than in investment grade debt.

Finally, it is necessary to use adequately LMT mechanisms such as swing pricing that force the redeeming party to pay the price of the liquidity, to take away any first mover advantages. These mechanisms should be used permanently, when needed, so that clients get to understand how they function. In addition, the swing factor needs to be defined so that there is a sound market impact.