International
Capital
Market
Association

ICMA AMIC response
FSB CP on MMF
13 August 2021

The International Capital Market Association (ICMA) welcomes the opportunity to comment on the consultation on the FSB's *Policy Proposals to Enhance Money Market Fund Resilience*. Our Asset Management and Investors Council (AMIC), the buy side voice of ICMA, was the key group in preparing the drafting of this response. It also draws on the work done by ICMA's Commercial Paper Committee.

Overall

1. What are the key vulnerabilities that MMF reforms should address? What characteristics and functions of the MMFs in your jurisdiction should be the focal point for reforms?

As a preliminary comment we encourage regulators to consider the overall chain of events in global capital markets around the March/April 2020 time as well as the broad MMFs/CPs ecosystem. An exclusive or narrow focus on MMFs may lead to the wrong diagnostic and inefficient regulatory developments. In our view, MMFs were the symptoms of a liquidity event rather than its cause.

We note that overall MMFs managed to fulfil their role in March-April 2020 and were a source of liquidity (none had to suspend or activate gates) in the middle of an exogenous crisis, which put tremendous pressure on short term liquidity and cash management of corporates, which are both issuers of money market instruments and investors in MMIs and MMF. This demonstrates that the MMF rules and risk management by MMF managers are overall fit for purpose.

Thus we don't think that there are 'key vulnerabilities' to address but rather an opportunity to finetune some prudential and sectorial rules which may have had a procyclical effect (see response to question 2) and enhance the resilience of underlying markets (see response to question 3).

2. What policy options would be most effective in enhancing the resilience of MMFs, both within individual jurisdictions and globally, and in minimising the need for extraordinary official sector interventions in the future?

Overall we believe that tightening of the current MMF rules as envisaged under the consultation would either threaten the viability of prime MMFs (e.g. Minimum Balance at Risk, capital buffer, eligible assets) or have a limited effect (e.g. swing pricing, liquidity fee) during the very short period when investors were looking for liquidity and most markets experience stress and illiquidity (even T-Bills).

We would however welcome the decoupling of regulatory thresholds from suspensions/gates/fees, which could indeed attenuate the first mover advantage. Delinking would also effectively allow buffers to operate countercyclically by enabling fund managers to use them to meet redemptions during times of stress, as was intended. This could also contribute to lower selling pressure on CP markets generated by the protection of liquidity buffers of MMFs. It would also allow to preserve the viability of MMFs which act as an alternative source of liquidity (on top of other products/institutions like banks) and therefore contribute to financial stability.

3. How can the use of MMFs by investors for cash management purposes be reconciled with liquidity strains in underlying markets during times of stress?

AMIC believes the focus should indeed be on measures to enhance the functioning and resiliency of underlying markets (such as CP and CD markets), rather than an overhaul of the regulatory framework governing MMFs (which can be finetuned via supervisors' guidance).

The fact that liquidity could temporarily disappear from CP markets was overall well-anticipated and managed by MMFs who structurally hold high balances of liquidity and typically meet redemptions from those buffers rather than having to sell assets.

Nevertheless, AMIC members see this as a key issue to be addressed post-crisis. Policy makers should consider whether prudential rules across the board had procyclical effects and in particular if (1) Basel 3 rules hindered the balance sheet capacity of market makers which was particularly detrimental to the CP and repo markets (intermediated by nature) and (2) margin rules could be improved to alleviate selling pressure on MMFs in times of stress (e.g. MMF unit made eligible as collateral). Banking regulation may have exacerbated the problem as the market pressure happened at quarter end when balance sheets are at their tightest. Money market instruments, although short and highly rated are considered level 2 and receive a haircut in High Quality Liquid Assets (HQLA) for Liquidity Coverage Ratio (LCR) calculations for banks.

Beyond prudential rules, enhancing the resilience of CP markets could also be achieved by improving the structure of the European CP markets. CP markets in Europe are still fragmented into subnational markets. Improving transparency would be a helpful start (price, investors base) while creating a truly pan-European market could be the ultimate goal (please see our response to question 17).

<u>**Forms, functions and roles of MMFs**</u>

4. Does the report accurately describe the ways in which MMFs are structured, their functions for investors and borrowers, and their role in short-term funding markets across jurisdictions? Are there other aspects that the report has not considered? `

5. Does the report accurately describe potential MMF substitutes from the perspective of both investors and borrowers? To what extent do these substitutes differ for public debt and non-public debt MMFs? Are there other issues to consider?

Investors : In a context of negative real interest rates, a stricter regime for prime MMFs may indeed simply push investors to favour fixed income funds that invest in relatively longer-dated assets than MMFs (i.e. residual maturity above 2 years) rather than public debt MMF. Opportunities to invest directly in CP may be an alternative for investors but the overall pool of CPs may shrink if this asset class becomes uninvestable by MMFs and as secondary market liquidity issues may worsen.

Issuers : In the absence of non-public MMFs, issuers may have to revert to more concentrated banking products, which could be problematic from a financial stability perspective. Many businesses prefer indeed CPs to bank loans for short-term financing because of the ease and efficiency in issuing CPs, the lower interest rate and given that it allows them to reduce their counterparty credit risk. We doubt that the other investors will replace MMFs and absorb CPs. In the US while MMFs exposure CPs shrunk by -65% from 2007 to 2019, the overall CP market decreased by -44% over the same period of time. MMFs reduced exposure (partly due to 2010 and 2014) was not fully compensated by other financial market participants (such as open-ended funds, pension funds or insurers).

<u>**Vulnerabilities in MMFs**</u>

6. Does the report appropriately describe the most important MMF vulnerabilities, based on experiences in 2008 and 2020? Are there other vulnerabilities to note in your jurisdiction?

We tend to disagree with the report when it states 'massive central bank interventions' related to CP markets and MMFs.

In the Eurozone, the intervention of the ECB in CP markets was relatively modest compared to other underlying markets. As of the end of March 2021, 96% of total net purchases are in public sector bonds, with 3% in corporate bonds, and 1% in commercial paper.

Furthermore, if the CP purchases by the ECB were relatively important in the first month of the crisis, it stopped after May 2020 and was not intended to provide relief to MMF but rather to help corporates as (1) around 95% of these transactions were made on the primary market and only 5% on the secondary market and (2) PEPP eligibility was restricted to a relatively small universe of issuers and did not include financial paper, which forms perhaps 80-90% of MMF CP holdings.

If the ECB actions contributed to improve market sentiment in Europe they did not solve all the issues. It was difficult to ascertain which CPs were eligible for the PEPP programme. CP purchases were not consistent across national central banks, which confused market participants including market makers. There was a lack of clarity in terms of the legal framework and what each central bank could buy.

The US Federal Reserve's program was more extensive than that of the ECB, providing lending facilities for dealers purchasing assets from MMFs, the "Money Market Mutual Fund Liquidity Facility" (MMLF) and purchases of money market instruments via the "Commercial Paper Funding Facility.

<u>Policy proposals to enhance MMF resilience</u>

7. Does the report appropriately categorise the main mechanisms to enhance MMF resilience? Are there other possible mechanisms to consider? Should these mechanisms apply to all types of MMFs?

8. Does the assessment framework cover all relevant aspects of the impact of MMF policy reforms on fund investors, managers/sponsors, and underlying markets? Are there other aspects to consider?

9. Are the representative policy options appropriate and sufficient to address MMF vulnerabilities? Which of these options (if any) have broad applicability across jurisdictions? Which of these options are most appropriate for public debt and nonpublic debt MMFs? Are there other policy options that should be included as representative options (in addition to or instead of the current ones)?

Summary :
Overall we believe that tightening of the current MMF rules as envisaged under the consultation would either threaten the viability of prime MMFs (e.g. Minimum Balance at Risk, capital buffer, eligible assets) or have a limited effect (e.g. swing pricing, liquidity fee) during the very short period when investors were looking for liquidity and most markets experience stress and illiquidity (even T-Bills).
We would however welcome the decoupling of regulatory thresholds from suspensions/gates/fees, which could indeed attenuate the first mover advantage. Delinking would also effectively allow buffers to operate countercyclically by enabling fund managers to use them to meet redemptions

during times of stress, as was intended. This could also contribute to lower selling pressure on CP markets generated by the protection of liquidity buffers of MMFs. It would also allow to preserve the viability of MMFs which act as an alternative source of liquidity (on top of other products/institutions like banks) and therefore contribute to financial stability.

Swing pricing : We agree that operationalising swing pricing in the context of MMFs may prove to be challenging. The use of such LMTs such as swing pricing in March/April 2020 would have not been effective as there was very little secondary market liquidity and transparency for underlying CP markets. Same day settlement and certainly intra-day settlement would be challenged should the use of swing pricing become mandatory. Low transparency into short term markets may make it difficult to calculate an appropriate swing factor, especially during times of stress (realistic bid/offer spreads). Disincentivising investors from redeeming their MMF holdings could be achieved by using a liquidity fee. But again, in March 2020, we wonder if this would have been very effective. Investor behaviour and reaction to a liquidity fee will largely depend on their need for cash and fund managers may be reluctant to use it because of the stigma associated with doing so.

Minimum balance at risk (MBR) : This would effectively require investors, after redeeming their shares, to assume the risk of losses if the fund's NAV were to decrease over a certain period. It would come with operational challenges as rightly described in the report, but more importantly, it is unclear how holding back a portion of each shareholder's redemption would inhibit large redemptions that stem from an aggregate increase in the demand for liquidity. The March 2020 crisis created a significant real need for cash – margin calls, other funding sources drying up, operational needs due to economic shut down. Finally, if this policy measure was imposed, we believe that investors would simply opt for different products and asset managers could exit the MMF market.

Capital buffer : The financing of the capital buffer would be costly and necessarily decrease the fund's return, and thus overall utility and efficiency of MMF as a cash management tool. Furthermore as explained by the report a buffer that is not large may exacerbate the first mover advantage. It may therefore only protect a certain fringe of investors from losses and do not address effectively the challenge of redemption pressures. If this policy measure was imposed, we believe that investors would simply opt for different products and asset managers could exit the MMF market.

Removal of ties between regulatory thresholds and imposition of fees and gates : We would welcome the decoupling of regulatory thresholds from suspensions/gates/fees, which could indeed attenuate the risk of first mover advantage. Delinking would also effectively allow buffers to operate countercyclically by enabling fund managers to use them to meet redemptions during times of stress, as was intended. This could also contribute to lower selling pressure on CP markets generated by the protection of liquidity buffers of MMFs.

Removal of stable NAV : We don't think that the March 2020 crisis would justify to ban stable NAV MMFs. Largest impacts were noted in USD LVNAV and EUR Standard VNAV. Investor behaviour in March was not driven by the MTM NAV but rather investors' need for cash. There is a clear investor demand for PDCNAV/LVNAV products as evidenced in AUM increases since MMFR entry into application and investor types across the globe utilising the products.

Limits on eligible assets : Futher limiting or banning investment in CPs would be a major issue for both MMFs investors/managers and MMI issuers (please see our response to question 5). T-Bills as well as Sovereigns, Supranationals and Agencies (SSA's) were also volatile and illiquid during March 2020 despite the fact that they are meant to be the risk-free asset. This demonstrates that the secondary market liquidity issue wasn't just confined to CPs. Mandating sovereign exposures (at the detriment of CPs) may not only be detrimental to the funding of corporates, it may also concentrate risk in the future and be inefficient in times of crisis.

Additional liquidity requirements and escalation procedures : MMFs managed to fulfil their role and were a source of liquidity (none had to suspend or activate gates) in the middle of an exogenous crisis, which put tremendous pressure on short term liquidity and cash management of corporates, which are both issuers of money market instruments and investors in MMIs and MMF. We therefore think that under current rules, MMFs are resilient enough to endure important redemption shocks. Given our reservations on the efficiency of LMTs in the context of MMFs and a liquidity crisis and our ask to remove the ties between regulatory thresholds and imposition of fees and gates, we would not be in favour of this policy option which seems to be mechanistic.

10. Does the summary assessment of each representative option adequately highlight the main resilience benefits, impact on MMFs and the overall financial system, and operational considerations? Are there any other (e.g. jurisdiction-specific) factors that could determine the effectiveness of these options?

11. Is the description of variants and the comparison of their main similarities/differences vis-à-vis the representative options appropriate? Are there other variants to consider?

12. Are measures to enhance risk identification and monitoring by authorities and market participants appropriate complements to MMF policies? Which of these measures are likely to be most effective and why? Are there other measures to consider? Considerations in selecting policies

Additional MMF reporting requirements to authorities : MMFs are already subject to extensive reporting requirement. In the EU, they have to provide at least on a quarterly basis a detailed list of information including the type and characteristics of the MMF, portfolio indicators, results of stress tests and information on the assets and liabilities held in the portfolio. While there could be some benefit in greater transparency provided to regulators, as we saw in March 2020 a stress scenario can materialise very quickly with little or no warning that would be picked up by traditional reporting obligations. It would be more relevant to require additional or more frequent reporting only during a crisis event and with a subset of data adapted to this type of situation (as it was the case during the March-April crisis).

Stress-testing : MMFs are already subject to extensive reporting requirements. In the EU, MMFs must, at least bi-annually, conduct stress testing that identifies possible events or future changes in economic conditions which could have unfavourable effects on the MMF. The MMF or the manager of an MMF must assess the possible impact that those events or changes could have on the MMF and is expected to act in order to strengthen the MMF's robustness whenever the results of stress testing point to vulnerabilities. For Public Debt Constant Net Asset Value (CNAV) MMFs and Low Volatility Net Asset Value (LVNAV) MMFs, the stress tests must also estimate, for different scenarios, the difference between the constant net asset value per share and the net asset value per share. An extensive report with the results of the stress testing and proposed action plan must be submitted for examination to the board of directors of the MMF, where applicable, or the board of directors of the manager of an MMF. The board of directors must amend the proposed action plan if necessary and approve the final action plan. The extensive report and the action plan must be kept for a period of at least five years. The extensive report and the action plan must be submitted for review to the competent authority of the MMF who in turn must send the extensive report to ESMA. ESMA has issued Level 3 guidelines with a view to establishing common reference parameters for the stress test scenarios to be included in the stress tests which managers of MMFs are required to conduct. The guidelines include stress test scenarios in relation to hypothetical changes in MMFs: liquidity levels; credit and interest rate risks; redemptions levels; widening/narrowing of spreads among indexes to which interest rates of portfolio securities are tied; and macro-economic shocks. In that respect, we note that the recalibration of stress tests issued on 16 December 2020 (awaiting translation at the time of writing) are significantly more stringent than previous and should go some way towards enhancing the robustness of MMFs.

Disclosure and reporting requirements on STFMs : We would rather be supportive of more transparency into the short-term market. Similarly to the underlying structure of the European CP market, transparency is also relatively fragmented, making it difficult to obtain a holistic overview of pre- and post-trade data, as well as comprehensive statistics on issuance, outstandings, and market structure. While there are a number of commercial initiatives that are helping to consolidate post-trade data and statistics across the different market segments, a level of fully consolidated publicly available information could play a role in supporting greater confidence for potential issuers, investors, and intermediaries, as well as helping with price formation, particularly in the secondary market. A consolidated tape for short-term markets, similar to those proposed for corporate bonds and equities, has been touted as a possible consideration.

13. Are the key considerations in the selection of policies to enhance MMF resilience appropriate? Are there other considerations that should be mentioned?

14. Which options complement each other well and could potentially be combined? What are the most appropriate combinations to address MMF vulnerabilities in your jurisdiction? Which combinations are most effective for different MMF types and their functions?

15. To what extent should authorities seek to align MMF reforms across jurisdictions? Is there a minimum set of policies or level of MMF resilience that should be considered at the international level to avoid fragmentation and regulatory arbitrage?

<u>Short-term funding markets (STFMs)</u>

16. Does the report accurately describe problems in the structure and functioning of STFMs and how these have interacted with MMFs in stress periods?

17. What other measures should be considered to enhance the overall resilience of STFMs? How would those measures interact with MMF policy reforms and how effective are they likely to be in preserving market functioning in stress times?

ICMA recommendations to enhance European CP markets
Extracted from ICMA white paper

In its discussions with members and stakeholders, and drawing on the lessons learned from the Covid market turmoil, four key themes can be identified from the perspective of potential vulnerabilities in the European CP market:

-Market fragmentation
-Lack of transparency
-Poor secondary market liquidity
-Lack of automation

While there are already a number of initiatives underway to address some of these challenges, market participants believe that more can be done to support the development of a more efficient and resilient pan-European CP market, involving all market stakeholders, including regulators and policy makers.

Market fragmentation

Stakeholders point to the fractured European landscape for CP, which consists of 1) the more international ECP market, which includes a significant USD denominated element as well as other non-European currencies, 2) the primarily French NEU CP market and 3) approximately 20 domestic markets of various size and development. Participants have indicated that they would like to see greater standardization and harmonization in terms of legal and regulatory frameworks, documentation, issuer eligibility, maturity and denomination profiles, and settlement cycles. Lower barriers to entry to the market, particularly for corporate issuers, would also be welcomed and which perhaps requires further analysis. While the STEP initiative is broadly recognized as being a concerted attempt to achieve improved standardization for the European CP market, adoption remains around 30% of the market, and the view is that more could be done to help to create something closer to a truly pan-European CP market in the spirit of CMU.

Transparency

Similar to the underlying structure of the European CP market, transparency is also relatively fragmented, and uneven, making it difficult to obtain a holistic overview of pre- and post-trade data, as well as comprehensive statistics on issuance, outstandings, and market structure. While there are a number of commercial initiatives that are helping to consolidate post-trade data and statistics on issuance and outstandings across the different market segments, a level of fully consolidated publicly available information could play a role in supporting greater confidence for potential issuers, investors, and intermediaries, as well as helping with price formation, particularly in the secondary market. A consolidated tape for short-term markets, similar to those proposed for corporate bonds and equities, has been touted as a possible consideration.

Secondary market

Perhaps one of the starkest realizations from the March-April 2020 turmoil is how thin and vulnerable the secondary market is for CP in stressed market conditions; noting that this is not unique to CP and that this was observed across a whole range of asset classes, including corporate and sovereign bonds. While CP is generally considered a buy-to-hold instrument, often matching investors' short-term liquidity horizons, its value as a money market instrument also hinges on its liquidity post-issuance, particularly in times of market stress. The fact that CP is a low margin, capital intensive business does not make it conducive to secondary trading; not least when banks' capital becomes a scarce resource.

There are a number of possible initiatives that could help to develop a functional, liquid secondary market:

-Capital and liquidity relief under the Basel rules to enable dealers to hold inventory, particularly in times of market stress. The Fed's move to provide capital relief to banks buying back eligible assets under the MMLF was instrumental in stabilizing the US CP market in March 2020. Recognizing highly rated CP as HQLA in capital ratios would at least be a positive step.

-A clearly defined 'back-stop' central bank purchase programme that provided a predictable 'bid of last resort' for a broad range of European CP (including financial and ABCP) would allow dealers to continue to support markets, particularly at times when balance sheet is restricted (such as over reporting periods), but more importantly in times of market stress.

-Developing a repo market for CP would afford dealers greater flexibility in funding inventory, as well as provide a means for investors to raise liquidity against their CP holdings without having to liquidate them. CP is eminently repo-able, including in triparty structures, but it is seldomly accepted by repo investors as it is difficult to value. Improved post-trade transparency, or even independently published CP repo curves (as provided by the Fed in the US market), would help to support accuracy and confidence in accepting CP as repo collateral.

-Broader central bank eligibility of CP in money market operations would enhance the repo-ability of CP and provide another funding option for dealers, particularly for financial CP/CDs and ABCP.

-As previously discussed, improved price transparency across the CP market would support confidence in price formation and valuations, helping to underpin secondary market liquidity.

-A more diverse investor base is viewed as being supportive of secondary market liquidity, particularly where there are different investment strategies or motivations for holding CP. Counter-cyclical flows help to smooth the high 'risk-on-risk-off' directional correlations observed with a more homogenous investor base, as well as attracting non-traditional liquidity providers.

Automation

While it is a truism that traders make prices, not venues, most market participants would agree that trading platforms can play a vital role in facilitating liquidity, at least under normal market conditions, both through consolidating multiple sources of liquidity and improving market transparency; as well as the core benefits of enhancing efficiencies in the price formation, execution, and settlement processes. While platforms, e-protocols, and new technologies generally develop organically and in response to market participant needs, as well as being driven by technological advances, it is important to encourage initiatives that help to promote standardization of data representation and processes as well as market interoperability. However, as illustrated by the Covid-19 turmoil, platforms are not a substitute for liquidity, particularly in times of volatility or market stress, and ultimately a CP market requires dealer expertise, intermediation, and capacity to take positions, in order to function as intended.

Additional considerations

18. Are there any other issues that should be considered to enhance MMF resilience?

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