IMMFA

INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

IMMFA Response to ESRB Recommendation and ESMA Final Report

Introduction

IMMFA is very supportive of efforts to make MMFs more resilient, through considered and proportionate reforms to enhance fund liquidity. There are elements of both the European Systemic Risk Board (ESRB)[1] and European Securities and Markets Authority (ESMA) proposals[2] which we welcome, such as delinking. However, in our view, the removal of the stable Net Asset Value (NAV) from the Low Volatility NAV (LVNAV) structure and the creation of mandatory public debt asset quotas are not the most effective ways of improving fund resilience.

Summary

- We support the recommendation to delink liquidity thresholds from the possible imposition of fees and gates. Removing the linkage frees up liquidity to be used as intended and effectively removes first mover advantage.
- We welcome the recommendation that all MMFs include the use of liquidity management tools and be able to choose the most appropriate form.
- We do not support the removal of the stable NAV from the Low Volatility NAV (LVNAV) category. There is little, if any, evidence to substantiate the suggestion that the stable NAV was a factor in fund outflows during the March 2020 crisis. On the contrary, Variable NAV (VNAV) funds in both the US and Europe experienced similar levels of outflow to LVNAVs suggesting the valuation method was not a key determinant. This is supported by ESRB data which shows that European LVNAVs dropped 12% whilst VNAVs dropped 13%.[3]
- The investor utility of the LVNAV fund is reflected in its 46% (EUR650bn equivalent) market share. Removing its key characteristic would have a detrimental impact on both investor choice and the provision of short-term funding.
- Prescriptive debt quotas introduce new and unnecessary risks. Public debt holdings should be interchangeable with other forms of daily liquid assets.
- Any proposals which require MMFs to hold higher liquidity should be accompanied by structural solutions to improve the framework of the short-term funding markets, allowing MMFs to fulfil their liquidity requirements in the optimal manner, as noted by the SMSG in their response to ESMA[4] and IMMFA in its Position Paper on improving resilience in the short-term markets. [5]

Section I - Removal of the stable NAV for LVNAV MMFs

Both the ESRB and ESMA[6] propose removal of the stable NAV from LVNAV MMFs on the basis that it creates the risk of first-mover advantage risk. The stable NAV is fundamental to the utility of LVNAVs and the value proposition offered by these funds to investors, as reflected in their 46% (EUR650bn

[1] Recommendation of the ESRB on reform of money markets (ESRB/2021/9), 2 December 2021.

[2] ESMA Final Report, ESMA opinion on the review of the Money Market Fund Regulation, 16 February 2022.

[3] ESRB Issue note on systemic vulnerabilities of and preliminary policy proposals, July 2021, p.20

[4] Securities and Markets Stakeholder Group, Response to ESMA's Consultation Report on 'EU Money Market Fund Regulation', 30 June 2021.

[5] IMMFA Position Paper, 'How to improve the resilience of the short-term funding markets', March 2022.

[6] ESMA refer to removal of the amortised cost valuation and 2 digit rounding separately. Taken together the prohibition of these two conventions would remove the ability of LVNAVs to offer a stable NAV.

equivalent) market share. We believe the prohibition of the stable NAV could be deeply disruptive for investors, possibly forcing them into riskier alternatives. Reduced investor appetite could have a detrimental impact on the industry with broader implications for short-term funding and the real economy.

- There is little, if any, evidence that the 20bps collar caused first mover advantage during the March 2020 crisis. The crisis was a systemic liquidity event and investors were focused on liquidity thresholds and the implications this would have on access to their cash, not NAVs. The overwhelming majority of funds stayed well within their collars with not a single LVNAV MMF breaching the 20bps threshold.
- Removing the ability to trade in and out of an LVNAV at par means the fund structure loses its core utility value to investors. Given lack of capacity in the bank deposit market, noted by the ESRB in their Report[7], we believe investors may be forced into less transparent and less resilient products, transferring risks to other parts of the system.
- Fund resilience is best improved by measures to improve liquidity. The ECB analysis supports this view in suggesting that removal of the stable NAV may not be required if LVNAV liquidity were sufficiently strengthened. [8]
- The ESRB and ESMA both note the importance of preserving the funding capacity of MMFs. The ESRB[9] and the ECB in their analysis[10] also note that the removal of the stable NAV from US Prime funds was a contributory factor in the USD1trn shift into government MMFs after the 2014 reforms. Any such migration out of the EUR650bn (equivalent) LVNAV assets under management (AUM) into PDCNAVs could have a significant effect on the market's ability to mediate short-term funding for private debt issuers. This is particularly a risk in the USD sector, where PDCNAVs offer an alternative.
- By way of context, we add that during the March 2020 crisis, it would have been incompatible with the key objectives of an MMF, namely the preservation of capital and provision of liquidity, to continue to deploy liquidity at a time of significantly increased redemption pressure.
- Additional uncertainty will be introduced due to the lack of clarity around the accounting and tax treatment of an MMF which does not maintain a stable NAV. In the US, the SEC and IRS issued guidance with respect to accounting and tax treatment. Similarly, in 2018 the AMF provided guidance that both short and standard MMFs authorised under MMFR benefitted from cash equivalence.[11] Given the multi-jurisdictional nature of investors in EU-domiciled MMFs this is not something that can easily be achieved on an EU-wide basis.

We would also like to address specific points in the ESMA Final Report

- The Opinion states that when faced with redemptions LVNAVs were subject to a trade-off to 'either sell liquid assets to maintain their NAV at the risk of breaching WLA or sell liquid assets to maintain the WLA at the risk of breaching the NAV collar'.[12] MMFs were not selling liquid

[7] ESRB, Report on the economic rationale supporting the ESRB Recommendation of 2 December 2021 on money market funds and assessment, January 2022, p.2.
[8] ECB, Mind the liquidity gap: a discussion of money market fund reform proposals, p.1.
[9] ESRB Report, as above, p.22.
[10] ECB, Assessing the impact of a mandatory public debt quota for private debt MMFs, section 'assessing possible costs', p.6.
[11] AMF, Q&A on Money Market Funds, Guide for Asset Management Companies, p.29.
[12] ESMA Opinion, 3.1 Annex, paragraph 11, p.13.

assets to maintain their NAV. From a weekly liquidity perspective there would be no benefit in selling WLA to convert it to cash as WLA would remain the same. WLA was the most important metric as it was tied to fees and gates and was therefore the primary focus of investors.

- The Opinion states that removing the stable NAV would have the largest impact and maximum redemptions could increase from 40% of NAV to 80%.[13] This is not supported by market evidence. Neither Standard Euro MMFs, which are Variable NAV, nor US Prime funds[14], which are floating NAV, were able to provide liquidity more easily than LVNAVs in Europe as liquidity was a function of market conditions. The ability to sell securities is not determined by the NAV methodology.

Section II - ESRB Recommendation for a mandatory public debt quota

We strongly recommend that portfolio managers be given discretion over how best to meet liquidity requirements in order to do so in the best interests of the shareholders, according to market conditions.

i) A public debt quota is not the optimal way to improve liquidity

- A prescriptive public debt quota would introduce additional and unnecessary risks and is not the most effective way of enhancing liquidity.
- If the motivation is to increase liquidity, then nothing is more liquid than cash and the focus should be on levels of liquidity. The suggestion is that a public debt quota would avoid the problem of the 'relatively long lead time of weekly maturing assets' but holding more daily liquidity would be more effective in this respect. The provision which allows MMFs to use overnight deposits or repo secured on government collateral in a situation where the supply of public debt assets is not sufficient implicitly recognises that such assets are equal or better in terms of liquidity. In addition, the provision does not fully solve the problem as deposits and repo are heavily constrained at certain times of year.
- Portfolio managers should have flexibility and discretion over how to meet any increased liquidity requirements. Any public debt component should be interchangeable with other overnight deposits or overnight reverse repo secured with government collateral.
- The goal should be to allow portfolio managers to source liquidity in any given market conditions as these can change dramatically not only due to a 'black-swan' systemic event such as the March 2020 crisis, but due to changes in market supply and demand which have become a recurrent source of price dislocation.

ii) It increases maturity transformation and interest rate exposure

- Holding public debt assets beyond a week *increases* maturity transformation, contrary to the objective of reforms.
- Crucially, it also increases the potential for mark to market losses, a risk acknowledged by ESMA[15] who note the price volatility relative to shorter weekly liquid assets (WLA) also noted by IMMFA in our response to the ECB proposal.[16]

[13] As above, paragraph 12.
[14] Pre the establishment of the Federal Reserve's Money Market Mutual Fund Liquidity Facility (MMLF).
[15] ESMA Opinion 'the price of debt with 190 days residual maturity is far more sensitive to change in interest rates than debt with 5 days to maturity', paragraph 52, p.23.
[16] IMMFA Response to the ECB on 'Consideration on MMF Reforms', pp. 4-5.

- During periods of rising interest rates, it is vital that portfolio managers have the flexibility to position their duration in a way which is aligned to their perception of risk. Prescriptive quotas could mean that a fund is forced to take on maturity risk when it is not in the best interest of shareholders to do so. At key reporting dates this could include being forced to buy public debt assets at levels which reflect temporary shortages, causing the fund to suffer mark to market losses which must be carried to maturity once market prices revert to normal.
- Additionally, even very short dated public debt assets can display significant differences in liquidity and related price volatility. For instance, short UK Gilts can behave very differently from UK Treasury Bills.
- Requiring a prescriptive allocation to a certain asset class increases susceptibility to shocks specific to that sector. A requirement to increase the sovereign weighting could be counter-productive in the event of a sovereign debt crisis or credit concerns about sovereign risk such as occurred in 2011. ESMA similarly notes that a mandatory quota introduces other risks such as magnifying pricing pressure on public debt assets in the event of a sovereign debt crisis.[17]

iii) Supply constraints

- The LVNAV sector consists of funds rated AAA (MMF rating) by one or more authorised credit agency which means they are restricted to holding only very highly rated paper. The lack of depth and uniformity in the European sovereign debt market would increase the challenge of fulfilling a quota. As the ESRB observes, 'the short-term government debt security market is less developed in the EU than in the United States'.[18]
- Our market experience suggests that holding higher levels of additional public debt will be extremely challenging both generically in certain jurisdictions and specifically at certain times of year. For example, in Sterling there is currently only GBP37.6bn in outstanding stock of UK T-bills. With the AUM of Sterling LVNAVs currently GBP228bn, an additional 15% public debt quota would be equivalent to almost the entire amount. These bills are already in high demand from pension funds and local authorities, as well as by banks for use as high-quality liquid assets (HQLA).
- The provision which allows MMFs to use overnight deposits or repo secured on government collateral in a situation where the supply of public debt assets is not sufficient implicitly recognises that such assets are equal or better in terms of liquidity.
- The proposal allows for a temporary drop in public debt assets in the event of a market wide issue. It does not contemplate the scenario where supply is available but only at a price which is detrimental to shareholders.
- Although there is ostensibly more supply in EUR denominated public debt, capacity constraints are regularly reflected in dislocated pricing around key reporting dates when there can be acute shortages of repo collateral as banks shrink their balance sheets, an effect which has been exacerbated by the introduction of bank levies. Public debt collateral is in demand from many different market participants, including, as noted by the ESRB[19], banks, who are the main holders and use these assets for their liquidity ratios.

[17] ESMA Opinion, paragraph 52, p.23.
[18] ESRB Report on the economic rational supporting ESRB Recommendation, p.2
[19] ESRB Report, as above, p.32.

- The data supplied by the ECB[20] as evidence of the feasibility of additional public debt quotas shows the size of the market but does not reflect accessibility. It also only relates to EUR denominated debt with a residual maturity less than one year that was short term at issuance.[21] It does not show the availability of the tenors which are most attractive to short-term (rather than standard) MMFs given the very strict limits on their duration (60-day Weighted Average Maturity/120-day Weighted Average Life). Many treasury bill auctions are for 6-, 9- and 12-month tenors. Whilst there may therefore be supply in the longer maturities, buying such paper would result in additional maturity/liquidity transformation and price volatility and would be very challenging given WAM constraints.
- A dramatic increase in the demand for highly rated short-dated public debt assets would exacerbate shortages which already cause market dysfunctionality and price dislocations at certain periods such as reporting dates.
- Whilst there is normally a plentiful supply of short-term government debt denominated in USD, even this can vary according to market dynamics. We note that even in the US onshore market, where qualified USD funds can access the Federal Reserve's Overnight Reverse Repo Facility (RRP), supply and demand dynamics have led to very high levels of usage, in excess of USD1trn since August 2021 and currently USD1.55trn.[22] This demand exists despite the US Treasury market being the deepest government debt market in the world. Offshore USD MMFs do not qualify for the RRP so may also be subject to supply constraints. Given there is no such comparable facility in Europe which would enable MMFs to find a home for cash, we would recommend that policy makers consider the creation of one.
- The vast majority of AAA-rated LVNAV MMFs do not make use of derivatives although this is allowed under the EU MMFR. It is therefore not an option to use either cross currency hedging to source paper or a derivative to shorten the duration of paper. Investors in IMMFA funds would not be comfortable if these elements were introduced into their LVNAV portfolios as it would add another layer of complexity and counterparty risk that is unnecessary. This means the funds must find public debt assets in their base currency, in the shortest possible tenor. The application of derivatives would, in any case, make the paper significantly less liquid.
- Neither issuance volumes nor the size of the MMF industry can be predicted. Even supposing supply is currently sufficient, both those metrics can change. It is not possible to predict how different governments will fund in terms of maturity tenor and volume.
- Relying on NCAs to provide timely interpretation of the caveat language regarding 'market-wide developments' introduces additional risk and possible ambiguity about how this would be defined.

iv) Counter-cyclical Buffers

- Liquidity buffers are intended to be used when unusual circumstances mean it is in the best interest of shareholders. Under the EU MMFR the use of liquidity buffers does not give rise to a regulatory breach. If an LVNAV (or PDCNAV) falls below 30%, the fund must not acquire any asset which does not contribute to weekly maturing assets (article 24 (1)(e)).

[20] ECB 'Assessing the impact of a mandatory public debt quota for private debt money market funds'.
[21] ECB, as above, section 'Assessing possible costs', p.6.
[22] https://www.newyorkfed.org/markets/desk-operations/reverse-repo

- We are concerned that the creation of countercyclical buffers, i.e., the ability to dip into buffers only when sanctioned, creates additional ambiguity around the use of buffers and may lead to continued investor reservations about the significance attached to their use. This could in turn lead to investors anticipating supervisory decisions by pre-emptively redeeming. In effect, this would introduce a new bright line.
- We suggest that the existing clarity of EU MMFR be leveraged to make clear that the use of buffers is permitted, as was always intended. We therefore suggest that the current wording be maintained, including the requirement to acquire only weekly liquid assets after a fall below the threshold.
- We believe this would achieve the objective, which we share, of improving fund resilience by improving liquidity.

v) Other points to be noted

- The ECB's assessment of possible costs[23] states that the return on bank certificates of deposit is around 20bps lower than that of Non-Financial Corporations (NFCs). This assumption uses Banque de France data and would reflect the fact that many NFC issuers in the French BTF market are unrated or have a lower rating than financial issuers. Many of these assets would not be eligible for a AAA-rated MMF from either a credit or duration perspective.
- The public debt holdings of standard MMFs included in the ECB analysis would include local/French regions and cities funding via the NEU CP market. Such instruments would not have the same liquidity as treasury bills issued by highly rated European states. Additionally, such issuance is not available in either the Sterling or US Dollar markets where regions and cities do not issue.[24]

Section III - ESRB recommendation for increased daily and weekly liquidity levels

IMMFA is supportive of efforts to enhance fund liquidity, but additional requirements should be both practicable and consistent.

- The impact of delinking on fund resilience and investor behaviour is being underestimated. Delinking provides access to the existing cash buffers which in the case of LVNAV MMFs are already substantial. This significantly increases fund resilience.
- We see no rationale for LVNAVs to hold higher liquidity levels if converted to a variable NAV. As ESMA note, LVNAVs have higher levels of liquidity and the possibility of using certain public debt assets to meet the requirements under Article 24 (1) (g).[25]
- The requirement for LVNAVs to hold higher levels of liquidity is inconsistent with the relative risk profiles of the fund types. The LVNAV sector consists of AAA rated funds which take significantly less duration risk than standard VNAVs. Data published by the ESRB itself shows that LVNAV outflows were 12% compared to VNAV outflows of 13%.[26]
- ESMA suggests that VNAV outflows differed in kind from those from LVNAVs because 'almost half the redemptions corresponded to long observed end-quarter outflows.'[27] IMMFA has

[23] ECB, as above, p.4
[24] We exclude US municipalities as these operate differently.
[25] ESMA Opinion 'no additional liquidity requirements should apply to LVNAVs', p.24.
[26] See footnote 2 above.
[27] ESMA Opinion, footnote, p.18

consistently argued that quarter end effects were an important factor in LVNAV outflows. We see no reason why such effects would be more pronounced in VNAVs than LVNAVs.

- Proposals to increase levels of liquidity, including holdings of public debt securities, need to consider the structural constraints in the market related to the scarcity of daily liquid assets (DLA) (and to some degree WLA) eligible investments both generally and, more acutely, around reporting dates, as noted above. This can result in severe price dislocations and capacity limits on the placement of cash at quarter and year ends, the cost of which is ultimately borne by the MMF investor. This lack of capacity creates a dynamic which forces MMFs to position themselves in a less liquid manner, thereby taking on unnecessary risk. This is less of a risk for USD markets as the Federal Reserve's Overnight Reverse Repo (RPP) facility meaningfully absorbs excess liquidity (indirectly helping EU domiciled USD MMFs). Currently, there is no such facility in GBP or EUR, and we would recommend that the creation of one should be seriously considered.

Section IV - Requirement for funds to have at least one form of liquidity management tool

Both the ESRB and ESMA recommend funds have at least one liquidity management tool (LMT). We agree that some form of redemption fee is the preferred way of imposing a transaction cost on shareholders leaving the fund and are supportive of the recommendations which allow flexibility of choice between different types of LMT.

The ESRB's objective of having prescriptive and quantitative parameters on deployment of fees risks the introduction of new threshold effects, which as the ESRB notes, is undesirable. The paper goes on to say, 'The choice of which tool to use, the activation of the tool and the specific calibration of its deployment should be left to the discretion of the fund manager, subject to the overall requirements and guidance of the framework'.[28] We would support the suggestion that fund managers and ultimately fund boards should have discretion over how and when to deploy LMTs in the best interests of the fund's investors. Such tools were not used during the crisis because they were not required.

ESMA address the tension between discretion and prescription by suggesting that LMTs should be activated by the fund manager with criteria for use to be included in a delegated act. We would support this approach, provided it is principles-based and not overtly granular and agree with ESMA's point that it is important not to create new threshold risks.

We agree that further work is required to develop the criteria and we look forward to engaging on this.

Section V Enhanced monitoring and stress testing

We support measures to refine monitoring and stress testing where this would add materially to efforts to identify risks.

[28] ESRB Report, p.19.