association of the luxembourg fund industry

Luxembourg, 16 August 2021

Response to the FSB consultation on policy proposals to enhance Money Market Fund resilience

Introduction

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank the Financial Stability Board for the opportunity to participate in this consultation on Policy Proposals to Enhance Money Market Fund Resilience.

Response to the consultation

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?

At the beginning of the COVID-19 pandemic, the outlook of a potential economic crisis triggered significant risk aversion and the demand for cash started to increase (ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 29). As a result, market liquidity came under pressure and fell sharply, not only for riskier assets, but briefly also in high-quality markets, such as the US Treasury and money markets, as both financial and non-financial sectors demanded cash (ECB Financial Stability Review, May 2020 p. 7 and the respective graphic 1 in our attachment). European investment funds experienced outflows for different fund types, including, but not limited to, Money Market Funds (MMFs) (ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 35 and the respective graphic 2 as well as graphic 1 in our attachment).

In this context also some segments of the EU short-term MMF industry faced liquidity challenges, in particular LVNAV MMFs while CNAVs recorded high inflows and VNAVs overall limited outflows although individual VNAV funds may have been subject to large outflows (ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 32 and the respective graphic 3 in our attachment). In general, outflows were amplified by seasonal, quarter-end factors in view of non-financial corporate investor redemptions in the second half of March, whereas those of other clients segments remained

Association of the
Luxembourg Fund Industry
a.s.b.l.
12, rue Erasme
L-1468 Luxembourg
B.P. 206
L - 2012 Luxembourg
Tel: +352 22 30 26 - 1
Fax: +352 22 30 93
info@alfi.lu
www.alfi.lu
TVA LU 23710105
R.C.S. F4428

more stable (see e.g. EFAMA, European MMFs in the Covid-19 market turmoil, November 2020 p. 11). In this context, we would like to point out the market impact of quarter end balance sheet pressures on liquidity. As banks reduce their balance sheets approaching reporting period ends, this directly impacts both the amount of liquidity a MMF can hold in the fund, and also how liquid the market is. Redemption pressure timed ahead of a quarter end was in our view a material factor in the lack of liquidity in markets.

Among the outflows, the ones from both euro and USD-denominated funds were significant, especially USD-denominated LVNAV funds, while preliminary USD-dominated CNAV funds received net inflows (ECB Financial Stability Review, May 2020, p. 86 f.). This could also be observed for Luxembourg MMFs (IOSCO Thematic Note, Money Market Funds during the March-April Episode, November 2020, p. 8 and the respective graphic 4 in our attachment).

In the USA, similar developments took place with a large rebalancing between Prime MMFs and Treasury & Government MMFs (here and the following: ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 32 f.). The US Federal Reserve started to support US MMFs through lending facilities for dealers purchasing assets from MMFs, the so-called “Money Market Mutual Fund Liquidity Facility” and through outright purchases of money market instruments via the “Commercial Paper Funding Facility”. In the Euro area, the European Central Bank (ECB) put in place a purchase programme of commercial paper issued in euro by non-financial corporates, the so-called Pandemic Emergency Purchase Program (PEPP). However, it has to be noted that European USD MMFs were neither eligible for the US Federal Reserve facilities, nor for the ECB Commercial Paper programme. Overall, the PEPP only provided limited support to MMFs as it covered only debt issued by non-financial companies and denominated in euro whereas European MMFs invest predominantly in commercial paper and certificates of deposits issued by financial institutions and denominated for the most part in non-euro currencies (EFAMA Market Insights October 2020 – Money Market funds in Europe – State of Play, p. 6). According to our understanding, the Central Bank intervention also rather aimed in the first place at addressing systemic risks in general that arose during a market liquidity crisis than at addressing risks in MMFs in particular.

At the end of the first quarter 2020, the situation relaxed and inflows into MMFs were observed as graphics 1-3 show.

Even though there was neither a direct support of European MMFs by the US Federal Reserve via its programmes nor a broad support by the ECB via the PEPP, their quick reaction helped to maintain investor confidence in the market and thereby limited the impact by investor behaviour. However, the intervention may have led to the impression that MMFs were not resilient enough.

In this context, we do not agree with page 4, second paragraph, last sentence of the consultation report which states *Secondary markets for CP and CDs are generally not liquid as investors, including MMFs, tend to buy and hold these instruments to maturity.* In normal market conditions there is sufficient liquidity. The portfolio construction of MMFs organically has high levels of liquidity as it holds at least 30% WLA. Assets within the WLA will generate cash due to natural maturity schedule without the sale of any position. Therefore, the need to sell to meet redemptions from investors is very limited in normal times due to the nature of the instrument. Moreover, it should be noted that short-term European MMFs entered March 2020 already with weekly liquidity levels well above their regulatory minima and that the average liquidity levels for the whole first half of 2020 remained at around 50% (EFAMA, European MMFs in the Covid-19 market turmoil, November 2020 p. 17). In addition, it is worth mentioning that when the crisis evolved, the demand for cash resp. liquidity existed predominantly in the US, as the existing market conditions had already been tighter and the banking system did not contain reserves in the same way as it was the case in the Euro area (ECB Financial Stability Review of May 2020, p. 39).

Moreover, despite the liquidity challenges faced by European MMFs, none of them had to introduce redemption fees or gates or suspend redemptions during the market turmoil in March 2020 (ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 34). This as well as the quick recovery show that the systems operated well. The crisis was rather an evidence of the resilience of the MMFs in Europe and does not per se justify any amendments to the Money Market Fund Regulation (MMFR; Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on Money Market Funds).

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?

The extreme circumstances of the sudden pandemic in March 2020 (liquidity constraints in the STFM due to investors' uncertainties, run for cash, combined with very limited dealer intermediation) have proven the resilience of the European MMFR. Indeed, despite the fact that, as mentioned above, European MMFs did not have direct access to the plans put in place by the US Federal Reserve nor the ECB (and hence the limited indirect positive impacts of these plans on the European MMFs), all European MMFs honoured their redemptions, without activating fees or gates mechanisms. As a result, there were, despite the sudden abrupt circumstances, no contagion or amplification effects attributable to MMFs.

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?

Forms, functions and roles of MMFs

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?

See our response to question 2.

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?

We welcome the comparison made by the report between MMFs and their substitutes, including the evident benefits of MMFs for investors (stability, liquidity, yield, risk diversification) and borrowers (cost savings, diversification, flexibility, currencies).

Vulnerabilities in MMFs

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?

Policy proposals to enhance MMF resilience

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?

As mentioned above, the crisis was rather an evidence of the resilience of the MMFs in Europe and does not per se justify any amendments to the Money Market Fund Regulation (MMFR; Regulation

(EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on Money Market Funds).

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 non-public debt MMFs? Are there other policy options that should be included as representative options (in addition to or instead of the current ones)?

a) Swing Pricing

Liquidity management tools ("LMT") are used to ensure a fair treatment of shareholders, in particular in exceptional market stress situations. LMTs actually provide a broad tool box, which supports both the daily management of funds and the management of crises.

However, Swing-pricing should not be mandatory as we do not believe this would bring an added value, particularly for short-term papers. We believe that the concept of a mandatory swing threshold is not meaningful for MMFs. A swing threshold is the level of net flows at which a fund would determine to swing the NAV (e.g., a fund might swing the NAV if a fund experiences a net 5 percent inflow or outflow). This makes sense in the context of long-term funds, because while such funds typically maintain some cash and overnight assets with which to meet redemptions, a larger flow will require transactions in the underlying portfolio, imposing the costs swing pricing is intended to address. MMFs, on the other hand, routinely hold substantial amounts of short-term and maturing assets, and regularly see predictable, high levels of inflows and outflows (e.g., at month and quarter end). Moreover, given the short duration of MMF assets generally, portfolio managers can plan for these redemptions by allowing portfolio assets to mature, rather than transacting in the secondary market. Thus, tying the execution of a NAV adjustment to net flows, as with swing pricing, does not bring any added value for MMFs on a mandatory basis.

Additionally, to assess daily net flows for purposes of determining whether the swing threshold has been met, MMFs would likely need to suspend intraday settlement, a feature of MMFs that is highly valued by investors. Same-day settlement (once per day) could also be compromised. This is because all daily flows must be received, and the NAV calculated, before a price can be swung, meaning that intra-day pricing could not incorporate a swing. The end-of day operational process would also likely take several hours, so unless a fund stopped accepting transactions early, it would be unlikely to meet the deadline for same-day settlement.

Generally speaking, ALFI is of the opinion that the use of Liquidity Management Tools should be left at the board's discretion. Please also note that ALFI has historically argued that Swing Pricing is an anti-dilution tool, not a true liquidity tool, and that mandatorily imposing its introduction would have significant impacts on LVNAV and CNAV structures and thus investor behaviours.

As clearly disclosed in ESMA's recent Report on the ESRB Recommendation on liquidity risk in investment funds (ESMA34-39-1119) (the "ESMA Report"), LMTs are already extensively available in several EU jurisdictions.

b) Minimum balance at risk

We do not see the merit of this proposal. In the context of the March 2020 event, large redemptions were due to investors wishing to raise cash due to market uncertainties and not linked to a "First-mover advantage" consideration.

c) Capital buffer and proposed variants

As regards the proposals of creating a capital buffer fund or any liquidity exchange bank (LEB), we would like to comment as follows:

As in our view, MMFs proved to be resilient during the onset of the crisis and proved that the current system worked well, we do not see the need to establish a capital buffer. In the current low yield environment, a capital buffer would create even further costs for the funds that eventually may have to be borne by the investor.

In addition, we see the risk that for the purpose of the capital buffer or the LEB, funds could be grouped regardless of how they are being managed which could create additional unnecessary administrative burdens.

The crisis highlighted that MMFs already have sufficient tools at their disposal to manage a liquidity crisis. Therefore, a capital buffer or a LEB is not necessary.

A capital buffer would also further enhance the misguided perception of MMFs that they are guaranteed investments. Much of the regulatory reform work on the MMFR has been to remove this perception, a capital buffer would undo this.

Concerning the suggested variant of sponsor support, we would like to refer to art. 35 MMR which prohibits external support for MMFs. At this stage we do not see the need to amend or clarify this provision.

d) Removal of ties between regulatory thresholds and imposition of fees and gates

ALFI supports the proposal of removing the automatic link and instead leaving it at the responsibility of the board to impose these measures to the fund when it is in the best interest of the fund, without reference to any specific level of liquidity. In our view, this could lower the risks of investor outflows as especially gates can have a negative connotation for investors. In addition, this would fall in the already existing responsibilities of the board as under the current requirements by the MMFR, it needs already to perform an assessment of the situation and to determine next steps when liquidity falls below the thresholds. As an alternative, in times of stress, regulators could grant some exceptional leeway from the 30% WLA requirement.

e) Removal of stable NAV

Referring to our response to the recent ESMA consultation on the MMFR legislative review, we would like to reiterate that based on our experience, the recent market developments did not raise any particular concerns regarding the CNAV and LVNAV regime.

These types of MMFs are particularly useful for certain markets and investors. Therefore we strongly advocate against an elimination of these fund types. MMFs are an important source of short-time financing in general and for European governments in particular.

Institutional and corporate investors may prefer to have these options of amortized cost methods of CNAV and LVNAV funds. These funds are particularly useful for the proper functioning of the corporate treasuries and money markets in general.

During the crisis many VNAV funds also experienced significant outflows. Conversely, USD CNAV funds seen increased demand from investors during the crisis. If these fund types were to be eliminated, this could lead to a moral hazard where investors would seek to find alternatives which may be subject to capacity constraints and risks, or may turn to unregulated products.

f) Limits on eligible assets

Eligibility of assets is already adequately addressed in the European MMFR.

g) Additional liquidity requirements and escalation procedures

We do not agree with the need of increasing the liquidity buffer. But the daily and weekly liquidity buffers should be adaptable to the circumstances by the management of the fund in the interest of the investors or in very exceptional market circumstances, by the regulator. There should be no direct link between the liquidity requirements and the use of redemption fees and gates. We would welcome any flexibility provided in this regard.

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?

a) Stress testing

There are several items that should be taken into consideration.

1) In Europe, the current requirements are very much detailed already. No other area/asset class/fund type faces as detailed requirements. These requirements are sufficiently comprehensive in our view.

2) Furthermore, we would like to stress that we are not in favour of any mandatory actions when thresholds are breached as they could lead to investor and/or market wide detrimental outcomes (e.g. market impact, herding, liquidity dry up).

3) We would propose to require that managers develop a clear contingency plan that includes stress testing, like it is required e.g. for liquidity risk management. In our view, this would be a better way to ensure each organization has thought through such adverse scenarios and is prepared to face such outcomes.

b) Additional MMF reporting to authorities

MMF reporting to European authorities is already addressed under MMFR.

It should be distinguished between reporting under normal and under stressed conditions. Under stressed conditions, a more frequent reporting could be useful. This could be covered by additional ad hoc reporting as needed. To our knowledge, the additional ad hoc reporting that was introduced by National Competent Authorities (such as the IFM notification on fund issues and large redemptions that was launched by the CSSF) at the onset of the pandemic proved to be very effective and useful to monitor developments. Therefore, we do not believe that there is a need to review the existing reporting requirements under the MMFR.

Considerations in selecting policies

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?

Short-term funding markets (STFMs)

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?

Additional considerations

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