FSB FINANCIAL STABILITY BOARD

Liquidity Preparedness for Margin and Collateral Calls: Consultation report

Response to Consultation

IMMFA Institutional Money Market Funds Association

1. **Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?**

   The FSB's approach thoroughly examines non-bank market participants internal liquidity preparedness, focusing in particular on risk management, governance and processes. We will not be commenting on these. We are suggesting that the FSB could also consider the wider implications of a measure which would enable market participants to utilise their cash stores more efficiently. This measure, namely facilitating the use of MMFs as margin collateral, requires regulatory reforms and closer regulatory alignment, elements which are extraneous to market participants and as such cannot form part of their own preparedness.

   We recommend consideration of permitting and facilitating the use of MMFs directly as margin collateral because it would have a very substantial material impact on improving general liquidity preparedness and overall systemic resilience.

   As regulatory reforms aimed at reducing counterparty risk have encouraged a move towards central clearing, the role of liquidity has become ever more important. As the FSB note, 'the functioning and resilience of the NBFI ecosystem depends on the availability of liquidity…under stressed conditions.' At the same time, prudential reforms have significantly suppressed bank appetite for short term deposits which has encouraged the use of MMFs. European MMF assets under management have almost doubled in the last 10 years, having grown from EUR832bn in 2013 to EUR1,705bn at the end of March 2024. They now play a unique role in providing a home for excess liquidity in the system.

   European Money Market Fund Regulation (MMFR) introduced in 2017 brought in restrictions relating to the credit quality, liquidity, diversification and maturity of investments intended to limit risk.[1] These provisions significantly strengthened MMFs, as demonstrated by the resilience shown during recent stress events. Further reforms have recently been implemented in the US and are being considered in Europe and we are confident that targeted, proportionate reforms can serve to enhance resilience further.

MMFs performed a vital function in providing liquidity during the recent liquidity stress events including the March 2020 'dash for cash' and the September 2022 turmoil in the UK gilt market. On both occasions, as market volatility led to spikes in margin and collateral calls, there was an observable correlation in MMF flow activity which, at times, exacerbated systemic liquidity strains. On both occasions, outflows were swiftly followed by substantial inflows, with a brief period of elevated redemptions reflecting market volatility, followed by sustained subscriptions directly thereafter. Facilitating the use of MMFs directly as collateral for margin calls would serve to reduce this procyclical pressure on liquidity and thereby contribute to overall systemic resilience.

We emphasise that during both stress events, MMFs served their purpose in providing same day liquidity in full and on time whilst remaining within their regulatory parameters. Nonetheless, regulators and policy makers have focused on how to further strengthen MMF resilience. The managers of an MMF have a fiduciary duty to act in the best interest of its shareholders. In a stress event, this is likely to mean the MMF must preserve liquidity. This has implications for the broader short-term markets, including the ability of issuers to access uninterrupted funding, and the likelihood of dealer banks being asked to intermediate. Reducing pressure on MMF redemptions therefore has obvious wider benefits in terms of overall market resilience. Allowing market participants to use their MMFs directly as collateral would be a means of reducing pressure on MMF redemptions.

2. **Is the scope of the proposed policy recommendations appropriate?**

   As noted, we are drawing attention to a possible policy measure which is beyond the scope of the recommendations, but which would certainly help in achieving the FSB's objectives.

3. **Is the focus of the FSB's policy recommendations on liquidity risk management and governance, stress testing and scenario design and collateral management practices appropriate? Are there any other areas the FSB should consider?**

   As noted in our response to question 2, we feel that it would be appropriate for the FSB to consider the broader collateral framework in this context given the importance rightly assigned to market participants' ability to access liquidity promptly and efficiently.

   We outline below the case for using MMFs as margin collateral.

   We believe that permitting and facilitating the use of MMFs as collateral for meeting the margin requirements would contribute to liquidity preparedness. MMFs have demonstrated both their resilience and the importance of their role in providing liquidity during recent stress events. This role has become more important as the need to move liquidity around the system efficiently increases with a drive towards the centralised clearing of the derivatives.

   Whilst the use of MMFs as margin collateral in uncleared transactions is technically permissible under EU regulatory requirements, there are a number of regulatory and operational barriers. This results in margin being, in practice, predominantly posted (and collected) in the form of cash.

It was clearly observable during the March 2020 ‘dash for cash’ that margin calls were a key driver of MMF redemptions for a certain sector of the investor base, primarily consisting of European pension funds and insurance companies who had purchased EUR denominated MMFs. In a volatile market, margin sensitive investors are more likely to redeem their MMF investments in order to meet increased calls for cash collateral. ESMA reached this conclusion in their working paper ‘Margin calls a new driver of MMF redemptions’.[1] This correlation was again observable in September 2022 when UK gilt prices were subject to historically unprecedented moves and, as noted by the FSB, UK pension funds employing LDI strategies experienced pressure on liquidity in order to meet increased collateral requirements. These investors exhibited the same behaviour in redeeming MMFs which they had used to store cash. Once markets stabilised, these flows were reversed, resulting in renewed and record inflows into GBP MMFs which then far exceeded pre crisis levels.

Once the investor has redeemed their MMF investment and posted cash, the receivers of the cash collateral, such as depository or custodial banks, have to reinvest the additional cash into liquid assets. This results in the collecting agent reinvesting in assets which are very similar to those owned by the redeeming MMFs, and in some cases into MMFs themselves. This circular scenario, whereby investors redeem from MMFs to post cash collateral, only for this to be reinvested in money market instruments by the collecting counterparty, has a detrimental procyclical impact as one form of liquidity is redeemed only to be recycled into another. It also has cost implications as there are direct brokerage or dealing costs on both selling the money market instruments and subsequently repurchasing them, costs which are ultimately borne by end investors and policy holders.

The advantages of investors being able to post and accept MMF units as collateral for non-centrally cleared derivatives would include:

• MMF assets would be retained in the MMF structure as opposed to liquidity being recycled.

• Market wide pressure on liquidity would be mitigated.

• The resultant reduction in procyclical flows would contribute to financial stability.

• The reduction in MMF redemptions would be conducive to continuity of short-term funding for issuers.

• The impact of Basel 3 is likely to mean a further reduction in bank appetite for non-operating cash deposits. It is likely this will be reflected in lower returns offered by custodial and depository banks currently holding margin in the form of cash. Allowing such banks to accept MMFs as collateral would broaden the investible universe.

• Increased ability to meet rising demand for collateral. The ability to use MMFs as an alternative to cash is helpful in the context of Uncleared Margin Rules (UMR) particularly given the objectives of Phases 5 and 6 to broaden the scope of counterparties subject to the margin rules, which will increase industry demand for collateral.

• Reduction in credit exposure to custodial banks. As noted by ISDA, 'reinvesting cash into a money market fund may also reduce custodian risk in the event of a custodian bankruptcy because cash posted as collateral is attributed to the custodian's balance sheet and securities such as money market funds are not' .[2] The alternative is that investors carry on posting cash. In many cases recipients do not want cash, for reasons such as liquidity coverage ratios.

• Transparency requirements introduced under MMFR, ensure that MMFs offer exceptionally high levels of transparency on their portfolios, including daily and weekly liquidity levels.

Whilst our comments above apply to uncleared margin, in principle eligibility could subsequently be extended to cleared margin and other use cases using tokenised MMF shares as a method of payment. IMMFA has advocated for the broader application and more holistic approach. Permitting the use of MMFs as collateral for cleared transactions would require a change to EMIR technical standards. In addition, MMFs would need to be admissible collateral for CCPs.

Under current EU regulations, CCPs cannot accept MMF units as collateral. Although clearing members and CCPs are permitted to hold government MMFs in the US under CTFC rules, in the EU all MMFs are currently excluded under EMIR. This was revisited by ESMA in November 2021, but the conclusion was to continue to exclude them on the basis that regulatory changes were ongoing. Although changes are still a possibility, the European Commission has since (in July 2023) completed its report on the adequacy of current MMF regulation and found that it enhanced financial stability and successfully passed the test of recent market stress events. [3] Since CCPs often use a small number of commercial banks, MMFs would allow them an important means of diversifying credit exposure.

There are currently a number of operational and regulatory barriers to the posting and accepting of MMF units as collateral for non-cleared derivatives which we outline below. Some of the operational barriers could be overcome by the use of tokenisation but this would not remove the regulatory challenges which relate to interpretative issues and technical standards.

• Transferability: MMF units are not transferable like a bond and rely on a custodian effecting a book entry transfer. Tokenisation should make this operationally simpler by improving intra-day settlement and removing fund cut off constraints (see below).

• The haircuts have to be economically viable which is not the case currently. MMFs are treated as equity rather than debt which makes the haircuts prohibitive.

• UCITS funds must be eligible on a 'look-through' basis i.e., the assets they hold should be eligible outright. Since private MMFs such as LVNAVs invest heavily in bank paper and to a lesser extent in corporate paper, their assets may disqualify them from eligibility. Whilst this may be less of an issue for PDCNAVs, even for a these there may be obstacles. A further problem with PDCNAVs is that they only exist at scale in USD (as noted by the FCA), have limited traction in GBP, and are minimal in EUR.

- The inconsistent interpretation, across legislation, of concepts such as ‘highly liquid’ and ‘low risk’ is a barrier. For instance, under EMIR the use of UCITS (including MMFs) as collateral is allowed where the UCITS is limited to investing in cash and low risk debt securities. EMIR is silent on whether a reverse repurchase agreement backed by government debt is acceptable in this context and there is no clear regulatory guidance to the effect that it is. MMFR on the other hand, clearly envisages that a reverse repurchase agreement backed by government debt can be a high quality, low risk asset. PDCNAVS are in practice and by design the safest, most low risk UCITS/MMF available, yet the lack of clarity as regards EMIR definition of low risk means that counterparties may not be willing to accept them as collateral.

- There are cross-border regulation inconsistencies.

As mentioned, one development which will facilitate the use of MMFs as collateral is tokenisation of funds. The gradual adoption of tokenisation in funds including MMFs will reduce the operational barriers to posting MMFs as collateral. Tokenisation could enhance mobility, support delivery and increase transparency across the life cycle of a trade. It would make transfer of ownership less frictional by facilitating intra-day movement and settlement and obviate the need for custodians to update a shareholder register (and thus reduce processing time and operational barrier). Tokens representing the units would be traded and recorded on a distributed ledger which results in faster, cheaper and frictionless transactions. Investors would benefit from increased resilience in their collateral. Collateral providers would benefit from additional transparency, both of which would contribute to the FSB’s objectives.

Conclusion

As liquidity has become systemically more important, MMFs have served a vital role as a store for cash held in readiness for margin and collateral calls. The FSB’s consultation is an opportune moment to reconsider the use of MMFs as margin collateral and how this could be facilitated. This would alleviate procyclical pressure on MMF redemptions during a stress event thereby benefiting overall financial stability and make a significant contribution to improving liquidity preparedness.

4. **Is the approach to proportionality and materiality clear for all non-bank market participants?**

5. **Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?**

6. **Are the recommendations on liquidity stress testing and scenario design with respect to margin and collateral calls clear and sufficiently specified?**

7. **Are there any jurisdictional or sector-specific differences that are not accounted for in the recommendations?**

8. **Collateral readiness at the right time, quality and location is a critical aspect of effective liquidity preparedness for spikes in margin and collateral calls to mitigate**

the risk of having to liquidate collateral under stressed market conditions. Do the FSB's recommendations in Section 3.3 address all key elements required to be effective in mitigating liquidity risk arising from margin and collateral calls?

9. **Are there any material challenges to collateral management practices that some non-bank market participants may face that should be considered?**

If you have any additional comments, please provide them below.

IMMFA
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IMMFA Response to the FSB Consultation Report on Liquidity Preparedness for Margin and Collateral Calls

We welcome the opportunity to reply to the FSB's consultation on Liquidity Preparedness for Margin and Collateral Calls. Money market funds (MMFs) are widely used by non-bank market participants such as pension funds and insurance companies as a means of storing cash for daily cash management purposes, including in readiness for margin or collateral calls. As such, they form an important part of the framework supporting liquidity preparedness. Although not addressed directly in the consultation, we feel it is an appropriate moment to reconsider the use of MMFs as collateral as part of a broader evaluation of margin models. This would help neutralise a contagion channel to certain non-bank market participants such as insurance and pension funds and therefore reduce overall liquidity strains and bring a material benefit in terms of liquidity preparedness.

Since a number of the questions pertain specifically to risk management, governance and processes and we are making a broader point, we respond only to questions 1 to 3.

Introduction to IMMFA

The Institutional Money Market Fund Association (IMMFA) is the trade association which represents the European short term money market fund (MMF) industry. IMMFA's mission is to promote and support the development and integrity of the MMF industry by engaging with and informing policy makers and, amongst other things, providing a primary point of contact. IMMFA has 30 members, consisting primarily of asset managers but also custodial banks and other firms. Of the 30, 17 are asset managers (referred to as Full Members). IMMFA MMF assets under management (AUM) are currently over EUR1,100bn (EUR equivalent). This is comprised almost exclusively of institutional funds, denominated in three main currencies, USD, GBP and EUR, of which USD is the largest (USD608bn), followed by GBP (GBP231bn) and EUR (EUR199bn).[1] Although the overwhelming majority of IMMFA MMFs are stable Net Asset Value (NAV) in the form of either Low Volatility Net Asset Value (LVNAV) (78%) or Public Debt Constant Net Asset Value (PDCNAV) (18%), IMMFA represents all fund types and many of our members offer a range of funds.

[1] Figures as of 11 June 2024.

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As of 30 March 2024, the ECB reported total European MMF AUM of EUR1,705bn. On this basis, IMMFA MMFs accounted for 59% of the total in EUR equivalent terms.

Summary

As regulatory reforms aimed at reducing counterparty risk have encouraged a move towards central clearing, the role of liquidity has become ever more important. As the FSB note, 'the functioning and resilience of the NBFI ecosystem depends on the availability of liquidity…under stressed conditions.' At the same time, prudential reforms have significantly suppressed bank appetite for short term deposits which has encouraged the use of MMFs. European MMF assets under management have almost doubled in the last 10 years, having grown from EUR832bn in 2013 to EUR1,705bn at the end of March 2024. They now play a unique role in providing a home for excess liquidity in the system.

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[2] European Money Market Fund Regulation (EU) 2017/1131. US MMFs were also subject to reforms introduced by the SEC in 2014 and 2016, and most recently in 2024.

uninterrupted funding, and the likelihood of dealer banks being asked to intermediate. Reducing pressure on MMF redemptions therefore has obvious wider benefits in terms of overall market resilience. Allowing market participants to use their MMFs directly as collateral would be a means of reducing pressure on MMF redemptions.

Conclusion

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We look forward to engaging further on this discussion.