International
Capital
Market
Association

ICMA AMIC response
ESMA CP on MMFR review
30 June 2021

The International Capital Market Association (ICMA) welcomes the opportunity to comment on the consultation on potential reforms of the EU Money Market Funds Regulation (MMFR). Our Asset Management and Investors Council (AMIC), the buy side voice of ICMA, mainly drafted this response. It also draws on the work done by ICMA's Commercial Paper Committee.

Executive summary

Our response highlights that 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. This demonstrates that the MMFR and risk management by MMF managers are overall fit for purpose.

In the absence of MMFs or if MMFs had been unable to fulfil their obligations to their investors, redemption pressures would have been concentrated on other products/institutions like banks, which could be problematic from a financial stability perspective.

Overall we believe that tightening of the current MMF rules as envisaged under the consultation would have had no significant effect during the very short period where markets were illiquid. Requiring additional liquidity buffers or a Liquidity Exchange Facility would compromise the viability of MMFs. MMFs managers had to sell CPs and CDs to maintain their liquidity buffers, meaning that higher thresholds could have meant more selling pressure on these markets.

Using the current buffers in a contra-cyclical manner in period of stress is worth exploring but we don't think that this should be prescribed by the regulation but decided on an exceptional and ad-hoc basis by financial supervisors. We would also welcome the decoupling of regulatory thresholds from suspensions/gates/fees, which could indeed attenuate the first mover advantage. Supervisors could clarify that there is an obligation to consider relevant LMTs but not necessarily to deploy them when liquidity thresholds are breached. This can be achieved by ESMA or NCAs via guidelines and does not necessarily require modifying the level 1 text in our opinion.

AMIC believes the focus should 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 may have had procyclical effect 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).

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 sub-national markets. Improving transparency would be a helpful start (price, investors base) while creating a truly pan-European market could be the ultimate goal (c.f. ICMA white paper to enhance CP markets).

About ICMA

ICMA promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. It is a not-for-profit membership association with offices in Zurich, London, Paris, Brussels and Hong Kong, serving around 600 member firms in 60 countries. Among its members are private and official sector issuers, banks, broker-dealers, asset managers, pension funds, insurance companies, market infrastructure providers, central banks & law firms. It provides industry-driven standards and recommendations, prioritising four core fixed income market areas: primary, secondary, repo & collateral and sustainable finance. ICMA works with regulatory and governmental authorities, helping to ensure that financial regulation supports stable and efficient capital markets.

Q1 i) Do you agree with the above assessment of the difficulties faced by MMFs during the COVID-19 March crisis? Do you agree with the identification of vulnerabilities? ii) What are your views in particular on the use of MMF ratings by investors? Are you of the view that the use of such ratings has affected the behaviors of investors during the March crisis?

When considering lessons from March/April 2020 it's important to remember that this sudden, unique and unprecedented crisis has affected all markets including all safe haven asset classes (e.g. government bonds, gold, money market instruments). This is because of the nature of this crisis which was exogenous and not endogenous to the financial system or a specific market segment. When it comes to MMFs, we would like to highlight that measures to contain the spread of the virus 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 MMFs. The fact that MMFs managed to fulfil their role and were a source of liquidity (none had to suspend or activate gates) in the middle of a liquidity crisis demonstrates that the MMFR and risk management by MMF managers are fit for purpose. In the absence of MMFs or if MMFs had been unable to fulfil their obligations to their investors, redemption pressures would have been concentrated on other products/institutions like banks, which could be more problematic from a financial stability perspective. Overall we believe that tightening of the current MMF rules as proposed would have had no significant effect during the very short period where markets were illiquid.

However, fulfilling this liquidity function was not straightforward for MMFs at a time when redemption requests were large and sudden and as CP markets functioning was impaired. On the liability side, MMF managers faced clients in need of cash due to dropping revenues (corporate clients) or margin calls (institutional investors). Redemption pressures on MMFs were exacerbated by the fact that clients were not always able to raise cash by selling direct investments in CP markets. MMF managers also had to sell some additional assets to either maintain their WLAs or meet redemption requests but not all banks were able to make a market and when they did, volumes were limited as their balance sheet capacity was impacted by the overall need for cash from corporates (e.g., overdraft and loan facilities) and other prudential considerations (e.g., balance sheet allocation, loan loss provisions).

In light of these observations and the experience of our members, we believe the focus should 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.

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 may have had a procyclical effect 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 their nature), (2) margin rules could be improved to alleviate selling pressure on MMFs in times of stress (e.g., MMF units made eligible as collateral), (3) the protection of liquidity buffers of MMFs (otherwise escalation to gates/suspension) may have contributed to selling pressure on CP markets.

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 sub-national markets. Improving transparency would be a helpful start (price, investors base) while creating a truly pan-European market could be the ultimate goal (see ICMA recommendations below).

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. .

Regarding the objective to avoid interventions of central banks in the future we would like to highlight that the Fed and the ECB interventions were different in the way they targeted the CP market and MMFs. The Fed assisted money market funds in meeting demands for redemptions via the MMLF while also acting on CP markets. The ECB only provided relief to the underlying non-financial CP markets directly (€35 billion including only € 100 million bought from MMFs). The combination of these interventions contributed to improve market sentiment in Europe but did not solve all issues (financial CPs largest asset class for MMFs). The action the Fed took was a lot more decisive than the ECB and 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.

Finally, on the use of ratings by investors, ratings are generally viewed as very positive by investors as they give some assurance that a skilled independent party are reviewing portfolios. We do not consider that this is worth revisiting, as it was not a decisive factor during the recent crisis.

Q2 i) Do you agree with the above assessment on the potential MMF reforms related to the review of the MMF Regulation? ii) What are your views on the above mentioned assessment of the interaction between potential MMF reforms and the behaviour of investors during the MMF March 2020 crisis?

Please refer to our response to question 1.

Q3 Do you agree with the above assessment of the i) potential need to decouple regulatory thresholds from suspensions/gates and the corresponding proposals of amendment of the MMF Regulation ii) potential reforms of the conditions for the use of redemption gates? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

Decouple regulatory thresholds from suspensions/gates: We would welcome the decoupling of regulatory thresholds from suspensions/gates/fees, which could indeed attenuate the risk of first mover advantage. Supervisors could clarify that there is an obligation to consider relevant LMTs but not necessarily to deploy them when liquidity thresholds are breached. This can be achieved by ESMA via guidelines and does not require modifying the level 1 text in our opinion.

Q4 i) Do you agree with the above assessment of the potential need to require MMFs to use swing pricing and / or ADL / liquidity fees and the corresponding proposal of amendment of the MMF Regulation (including the above list of corresponding potential benefits and drawbacks)? ii) If you are of the view that swing pricing might not be workable for certain types of MMFs, which instruments would you suggest as an alternative for these types of MMFs going forward? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

Require MMFs to use swing pricing and/or anti-dilution levies (ADL)/redemption fees: Such LMTs are not traditionally used by MMFs given their nature and function, but they are legally available to them in most EU jurisdictions. 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. The suggestion that swing pricing could be applied only to redemptions and not subscriptions would create significant operational challenge for MMFs that operate a single NAV (currently all MMFs). 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 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/April 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. March 2020 created a significant real need for cash – margin calls, other funding sources drying up, operational needs due to economic shut down. Ultimately the use of LMTs should be at the discretion of fund managers and not mandatory (trigger effects).

Q5 i) Do you agree with the above assessment of the potential need to increase liquidity buffers and/or make them usable/countercyclical and the corresponding potential proposal of amendment of the MMF Regulation? ii) With respect to option 1 above, views are sought in particular on the relevant threshold (on the size of redemptions) from which WLA would need to be automatically adjusted. When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

- **Option 1 (current liquidity buffers to decline in case of specific circumstances):** Lowering the liquidity thresholds in periods of stress would not necessarily change investor behaviour (they would continue to focus on the normal levels as a 'bright line') but this could contribute to lower selling pressure on CP markets generated by the protection of liquidity buffers of MMFs. In any case we don't think that this should be included in the MMFR but decided on an exceptional and ad-hoc basis by financial supervisors.
  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 would be our preferred option.

- **Option 2 (adding a countercyclical liquidity buffer on top of current ones)** would threaten the viability of MMFs. It would make them unattractive not only from a financial perspective but also from a transparency perspective (investors would not know when the buffer would be increased or decreased). We are strongly opposed to this policy option.

- **Option 3 (fund with large investors to comply with larger liquidity buffers)** is built on the wrong assumption that all large investors of a certain type behave the same way and have similar liquidity needs under a stress scenario. It is impossible to forecast the nature of future crises and therefore the differing behaviour of different investor types that would unfold in those circumstances. In March 2020 as volatility went up, margin calls led to a need for cash, some institutional investors redeemed, others did not. Corporate activity was very different depending on the impact of the pandemic on business by sector and region (e.g. airlines shut down, supermarkets taking in record sale. It is therefore very challenging to draw conclusions on the redemption risk and anticipated investor behaviour during times of unprecedented stress based solely on the investor category.

Q6: What are your views on the potential need to eliminate CNAV and LVNAV funds, in light of the recent market developments, and the corresponding potential proposal of amendment of the MMF Regulation?

No, redemption pressure was different across different currencies and fund types. 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.

Q7: What are your views on the extent to which Article 35 of the MMF Regulation should be i) clarified ii) amended? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

In our view there is no need to amend the existing Article 35 under the MMFR. However, certain markets participants found ESMA guidance unhelpful because it came too late and was judged too restrictive (i.e. ability to buy assets at a fair price from an MMF limited to sponsor which is already an existing trading counterparty with the fund).

Q8 i) Do you agree with the above assessment of the potential need to assess the role of MMF ratings in light of the difficulties faced by MMFs during the March crisis, and the potential need to introduce regulatory requirements for MMF ratings? ii) In your view, based on your experience, what are the benefits of MMF rating from investors' perspective, having in mind that rules applying to MMFs are already very stringent? What would be the likely consequence on investors from the downgrade of one or several MMFs? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

Ratings had little impact on the way events in March unfolded. MMF managers were not behaving in a certain way due to having a rating, they behaved in the way they did due to: market conditions, expectations of investors and the regulatory requirements (mainly risk of fees/gates tied to liquidity).

Q9 Do you agree with the above assessment of the potential need to amend the requirements on stress tests included in the article 28 of the MMF Regulation? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

Part of the challenge here is that the 'action to strengthen the robustness of the MMF as result of stress testing, including liquidity and quality of assets' would likely be portfolio repositioning i.e. the sale of longer dated, lower credit quality assets to be replaced by more liquid, higher credit quality assets. This portfolio repositioning would most likely rely on the functioning of the short-term markets i.e. the ability for the MMF to sell assets and replace with more appropriate alternatives and is exactly what MMFs were trying to do in March 2020. The challenge was the lack of functioning of the short-term markets and the ability to quickly reposition without suffering significant cost. Enhanced stress testing does not solve for market liquidity issues.

The more stringent stress tests would not impact the investors behaviour but would impact the managers behaviour and would likely lead to more conservative portfolios. However we need to avoid creating more herd mentality – e.g. if managers all send their results to ESMA and ESMA tell managers reduce risk then you would again see consistent behaviour from managers all at the same time – this was in part the issue faced during March 2020, albeit not on the back of ESMA/Stress testing instruction.

At the moment it is very much at the manager's discretion what constitutes a vulnerability and what is the appropriate action should a vulnerability be identified. We would however 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.

Q10: Do you agree with the above assessment on the potential need to review the reporting requirements under the MMF Regulation? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80

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.

Given the short nature of MMF investments, a 'live' view of the fund could look very different compared with the regulatory filing by the time it is received. It would be challenging to speed up the production of the existing reporting given the amount of data and sources from which it is compiled.

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). But one needs to bear in mind that during a crisis event Fund managers and service providers (Fund admins and Transfer agents) experience significantly higher volumes of work (increased investor activity, increased market trading activity, valuation checks/challenges, tolerance breaches to be investigated, etc.).

Additional reporting would not influence investor behaviour as they do not see the reporting.

We don't believe that additional reporting would materially impact fund manager behaviour as the fund manager is concerned with running the fund in the best interests of investors, the reporting is just providing transparency into what has happened in the fund.

Q11: Do you agree with the above assessment of the potential need to include additional requirements in the MMF Regulation, and/or potentially in other types of EU piece of legislation on the disclosure of money market instruments (MMIs) and main categories of investors to regulatory authorities (e.g. detailed information on liabilities)? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

We would rather be supportive of more transparency into the short-term markets including the post trade information outlined above. 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.

Q12 i) Do you agree with the above assessment on the potential creation of a LEF? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.
ii) Several open questions related to the creation of the LEF, on which ESMA would specifically welcome feedback from stakeholders, include:
- **What should be the appropriate size of such a pooling vehicle as the LEF?**
- **In terms of funding, how much MMF would have to pay each year to participate in the pool? How much of the funding would/should be provided by other sources?**
- **How long would it take to establish such a LEF?**
- **Under which conditions would the LEF be activated?**
- **Who would be responsible for activating the LEF.**

A Liquidity Exchange Facility would compromise the viability of MMFs and one of the objectives of ESMA, which is 'the preservation of the key intermediation role that MMFs perform in the short-term segment of money markets' (recital 72). Ultimately this could lead to concentrate risks in other products/institutions, which could be problematic from a financial stability perspective.

Q13 Do you agree with the above assessment on the potential need of further clarification of the requirements of articles 1 and 6 of the MMF Regulation? When you answer this question, please also take into account the grid of criteria listed in paragraphs 76 to 80.

No, we see no need for further clarification.

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