EUROPEAN CENTRAL BANK

EUROSYSTEM

Considerations on MMF reforms
Key messages

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Background and rationale for MMF reforms: Structural vulnerabilities and risks to financial stability

- Private sector debt MMFs proved particularly vulnerable during the COVID-19 shock
- The key vulnerability relates to the liquidity mismatch between assets and liabilities.
- Sudden and decisive action by central banks was able to quell the financial market turmoil in March 2020
- Sufficient resilience of the MMF sector should be the first line of defence to avoid costly crises and limit moral hazard from central bank interventions

Way forward:

ESMA has recently launched a consultation for the framework on EU MMF with the aim to provide feedback to the Commission ahead of the scheduled legislative review of the EU Money Market Fund Regulation in July 2022.

Message 1: Improve asset side liquidity for private debt MMFs

Key vulnerability of liquidity mismatch requires imposing stricter limits on the percentage of liquid assets held by private debt MMFs:

- Since investors first and foremost use MMFs as a means to preserve capital and manage liquidity incl. cash, reforms must significantly safeguard these functions during stress times
- Modest minimum investments in public debt could sufficiently strengthen the liquidity profile of private debt MMFs
- Importantly, a reduction in liquidity mismatch cannot be substituted by measures (e.g. swing pricing) that attempt to make such MMFs more ‘investment-like’: proposed measures will not substantially alter investors’ perception/use of MMFs as cash management vehicle

Message 2: Address shortcomings of the regulation and further strengthen resilience

Impediments to the use of daily and weekly liquidity assets should be removed, and minimum requirements may be raised and made releasable:

- Removing the links between WLA thresholds and fees/suspensions will improve usability of liquidity buffers during periods of distress.
- A releasable buffer component could allow macroprudential authorities to act more effectively in adverse market conditions.

Removing the stable value for LVNAV funds may further strengthen resilience :

- It would have the benefit of fully removing unintended cliff effects related to the possible transformation from constant NAV to variable NAV in stress periods;
- Under the precondition that the funds’ liquidity risk profile is substantially improved, it might not be necessary to remove the stable value from LVNAV altogether.

Message 3: Possible complementing reform measures to account for liquidity risk

Swing pricing may be a useful complement to structural reforms, but it cannot replace them:

- Reduces incentives for redeeming and at the same time benefit investors that choose to remain invested; but could introduce new cliff effects
- Important to be mindful of the complexity of its calibration and limited effectiveness in addressing the key vulnerability of liquidity mismatch (particularly in crisis times).

The focus of reforms should be firmly on money market funds, while the integrity of post-crisis reforms for the banking sector should be maintained:

- The resilience of the banking sector during the COVID turmoil and its ability to help absorb the liquidity shock demonstrated the important role played by post-crises crisis regulatory reforms

Message 4: External support and liquidity exchange facility (LEF)

Support for keeping Article 35 of the MMF Regulation unchanged:

- It appropriately prohibits external support; coupled with guidance issued by ESMA last year, we see no need to further clarify what constitutes external support and what not.

A third-party LEF could help to mitigate redemption pressure in a crisis, but it must be designed to rely on market-based liquidity only:

- It has to be a private solution and not rely on central bank support to avoid moral hazard;
- To be effective in a crisis, a LEF would need to be of significant size, pre-funded, and require appropriate safeguards to limit MMF risk-taking arising from the presence of such a backstop.