EFAMA

European Fund and Asset Management Association

CONSULTATION RESPONSE

Brussels, 28 April 2023

EFAMA'S RESPONSE TO ESMA'S CONSULTATION PAPER ON THE REVIEW OF THE METHODOLOGY INCLUDED IN THE GUIDELINES ON STRESS TEST SCENARIOS UNDER THE MMF REGULATION (MMFR)

EFAMA welcomes the opportunity of this consultation to provide comments on the review of ESMA's Guidelines on stress-testing parameters for MMFs. Before turning to the specific amendments being considered to the existing Guidelines, we care to reiterate that, in the course of the March 2020 and over more recent episodes of market stress, liquidity management proved challenging for all short-term funding market participants. Throughout these episodes of market turmoil, European MMFs - whether short-term or standard and irrespective of their base currency denominations – have continued to meet redemption demands without breaching key EU MMFR requirements (including all of the liquidity-related ones). Moreover, they have continued to provide a high-quality, well-diversified and liquid investment option at a time when markets underwent considerable stress, while offering both investors and regulators complete transparency around funds' portfolio holdings and liquidity levels.

This high-level response wishes to draw out our concerns with some of the proposed amendments to the existing calibration, as well as question the overall rationale and feasibility of conducting "macro-systemic shock" scenarios.

I. Hypothetical changes in the level of liquidity

Regarding the **hypothetical changes in the level of liquidity** for the assets held in an MMF's portfolio (Q.2-Q.6), with the choice between the two price factor increase options – i.e. one depending on volumes sold and the another depending on market footprint – both would be imperfect in that they depend on the capacity of one or more MMF managers to effectively "sell" portfolio assets in a stressed market. From a close analysis of the March 2020 events affecting the functioning of European market for short-term money-market instruments (MMIs), and unlike the amended draft Guidelines assume, managers did face challenges in selling assets to begin with. Apart from widening spreads, it was the temporary absence of dealer intermediation and/or of credit institutions willing to buy-back their own MMIs (particularly the large amounts of financial commercial paper held by LVNAV and VNAV funds) that led to a situation where all market participants were practically unable to sell a large part of their holdings. This lasted until central bank refinancing operations and targeted waivers for dealer bank operations allowed for the resumption of the bidding process in the underlying MMIs. In this respect, in our June 2021 response to the ESMA consultation on the legislative review of the MMFR in Europe, we noted that by easing these restraints, dealers were progressively able to resume their role as liquidity providers in short-term funding markets (STFMs), while credit institutions resumed bidding in the commercial paper market, also by buying back

their own. Therefore, where the possibility for MMF managers to effectively “sell” portfolio assets becomes impaired, stress-tests calibrations based on sales and on their deriving price impact in turn would not be reliable. In this regard, we can only observe that the sought-after enhancements as outlined in the consultation report would be imperfect. Moreover, stress-test parameters could in this regard benefit from a more holistic calibration that considers an MMFs’ interactions with other key intermediaries active in short-term funding markets[1].

As a second important observation, ESMA should realise that the volume of asset sales is often only a fraction of an MMF’s outflows, given that the latter – as described above - can be honored by managers without necessarily dipping into the underlying markets. In fact, in relation to the March 2020 market events, there is ample evidence to suggest that European short-term MMFs could count on disposable liquidity “buffers” in excess of their MMFR liquidity ratios[2], leading them to weather mounting redemption pressures without breaching the latter. We care to note that the prudent adjustment of such liquidity buffers in anticipation of quarter-end flows, as well as in anticipation of future market conditions, lies at the core of the robust liquidity risk management process expected under the EU MMFR regime.

As a third observation with regard to the aforementioned options, we note that the consultation paper (as well as the amended draft Guidelines in the redemption scenarios specified under Section 5) specify that (…) *redemption requests will be calibrated according to the weekly liquidity stress test where the fund receives net weekly redemption requests from 40% of the professional investors and 30% of the retail investors*. While recognising the purely hypothetical nature of such thresholds, we would argue that they are not realistic for retail investors, as their historical weekly redemption patterns from MMFs have historically been far lower, even during very severe market corrections like in March 2020.

A fourth consideration concerns the design of the stress-test parameters, and in particular, in the hypothesis that all types of MMFs would be confronted with an identical external redemption shock, where the “price impact factor” would need to be calculated without accounting for MMF differences. As the March 2020 market episode has demonstrated, different MMF structures – across short-term and standard MMFs, currency denominations and jurisdictions – have experienced different flow dynamics, in turn the result of several factors, *inter alia*, a retail vs. institutional investor base, their underlying assets (private or public debt), minimum liquidity constraints, investor use (corporate cash management or other). A one-size-fit-all calibration of the parameters is therefore not ideal and would therefore need to be tailored to the specific type of MMF subject to the stress-test.

Lastly, a limiting factor for managers to reliably execute the recommended stress-test calibrations is data quality and its fragmentation. Known to ESMA are the difficulties in obtaining consistent, aggregate and timely information on money market data on which firms would rely to execute their respective stress-test calibrations. Accordingly, where the derivation of the proposed “price impact factor” is heavily data-dependent, its accuracy would inevitably suffer from the underlying data’s lack of precision and completeness, as well as from its variability.

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[1] In EFAMA’s August 2021 response to the FSB consultation report on policy proposals to enhance MMF resilience, we noted that in March 2020 dealers were also facing difficult choices, as these institutions sought to avoid a further expansion of their balance sheet by taking medium- to longer-dated assets onto their books, in view of their own prudential requirements and especially in light of their fast approaching quarter-end reporting obligations.

[2] This finding, as also corroborated in ESMA’s February 2023 EU MMF Market Report when presenting data on portfolio indicators for daily and weekly liquid assets (see pages 18-19), would therefore question the prevailing thesis that MMF managers would need to necessarily raise cash by selling portfolio assets.

II. Macro-systemic shock scenarios

As to the **macro-systemic shock scenarios** being advocated by the ESRB/ECB (Q.7-Q.9), we care to caution ESMA against the held belief that MMFs would forcefully have to sell assets to meet incoming redemption requests. As described in the previous section, evidence from the March 2020 market shock on the contrary suggests that MMFs were able to withstand redemption pressures precisely because they had ample liquidity to begin with, and at times well in excess of their regulatory requirements under the MMFR. Moreover, the direction of such flows reversed considerably in the following month of April 2020, proving the market dislocation to be only temporary. In other more recent instances (March 2023), as for instance in the immediate aftermath of the Silicon Valley Bank failure in the U.S. and its aftershocks affecting the solvency of a large Swiss credit institution, we observe that, in general, institutional investors in Europe have in fact been drawn into MMFs (even if on a milder scale compared to inflows recorded in the U.S. over the same period)[3].

In addition, we would also reiterate our earlier point made above, i.e. that a manager cannot easily dispose of a fund's securities absent the intervention of dealer institutions as critical important market intermediaries of financial MMIs. To the extent that the macro-systemic shocks under Option 1 (with a systemic impact on money markets) and Option 2 (with spillovers to short-term issuers) are necessarily, but wrongly, predicated on the automatic occurrence of asset sales, any calibration resulting from the proposed *formulae* promises to be misleading, notwithstanding ESMA's intent to study possible interconnections with other market actors. Moreover, in line with our previous considerations around the fact that the MMF industry is far from being as homogenous as the ESRB/ECB typically assume, we express great caution around an approach based on gross aggregations of individual fund stress-test results, as the latter will inevitably generate "false positives".

Complementing our doubts on the effectiveness of such calibrations, we would in addition note that stress-tests for MMFs – as well as for funds in general - should not be construed as "pass/fail" tests akin to those applied to the far more homogenous banking industry. Rather differently, stress-tests for funds (MMFs included) are to be viewed as important tools for portfolio/risk managers to use at the individual fund level to assist in the management of a fund's liquidity (while acknowledging its own asset and liability composition), alongside other liquidity management tools. The ESRB/ECB approach to therefore estimate potential system-wide consequences through the aggregation of a very heterogenous sample of individual funds' stress-test results remains ill-suited and is further complicated by data limitations and by the fact that MMF portfolios are moreover characterised by a high, intra-monthly turnover. Hence, any stress-test result – even at an individual fund level - would inevitably soon become outdated.

III. Climate scenarios in the stress-test methodology

Lastly, regarding the insertion of a **climate scenario in the stress-test methodology**, we concur with ESMA's conclusion that the exposure of MMFs to climate risks is generally limited compared with other types of financial intermediaries.

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[3] See for instance the 11 April 2023 article from Reuters.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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