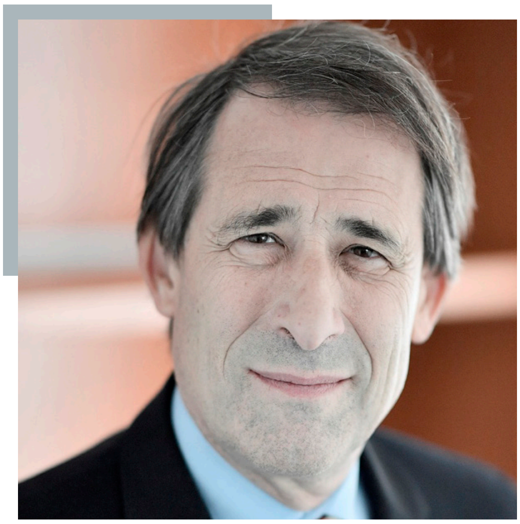

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NBFI put to the test by March/April 2020 events: the issue of money market funds

Open ended funds were buffeted by the financial consequences of the Covid-19 pandemic, both on the asset side (drop in valuations, high volatility, derivatives positions undergoing significant margin calls…) and on the liability side (waves of redemptions). All of which constituted a live test of their ability to weather problems of valuation and of liquidity. Amid these trials and tribulations, money market funds (MMF) came under a specific pressure: they recorded the largest redemptions and in some cases subscriptions while short-end debt markets, in which they invest, were themselves severely unsettled.

Bank sponsors (Europe aside) and above all central banks intervened to steady the short-term debt sector, which, although no accident was recorded, stood out as a major source of risk to global financial stability. Indeed, MMF are one of the main investors in these instruments and thus participate directly in funding the real economy, absorbing a major part of short-term funding of financial, non-financial and public-sector institutions, whilst enabling corporate treasurers, institutional investors and investment funds to place their excess treasury or cash.

This episode was striking: the MMF sector was one of the epicentres of the 2008 financial crisis and, in order to reduce the risks to financial stability that are associated with their functioning, deep reforms were undertaken in all countries. Actually the quality of assets held in their portfolio, notably their credit quality, did not raise any concerns in March or April. The 2020 crisis was a liquidity crisis caused by exogenous factors and it leads us to raise the question of the need for further reform of this ecosystem and, ultimately, the legitimacy of bank disintermediation for funds that are meant to be highly liquid and risk free, that are considered as a substitute for cash and besides, fall within the scope of money supply in many countries when held by resident non-financial agents.

Analysis of this episode however highlights the broad diversity of situations, notably when it comes to types of MMF. In the US, said Prime MMF invested in corporate paper recorded large redemptions while inflows into MMFs invested in public paper (Government & Treasury MMF) were nearly eight fold higher. In Europe, USD & GBP-denominated low volatility MMF (LVNAV), registered in Ireland and Luxembourg and mainly held by non-Eurozone residents, underwent large outflows, in these same countries offset by inflows into USD-denominated constant price public debt MMF (CNAV). And EUR-denominated MMF valued at their market price (VNAV), the greater part of which are registered in France, underwent severe outflows which were more sustained than with other types of MMF overall while bank deposits of their historical holders tended to grow.

In fact, amid a particularly uncertain economic environment with the closure of certain market segments, MMF holders reacted according to a given fund's characteristics its asset profile and associated regulatory constraints. Somewhat unexpectedly some of these regulatory constraints could have spurred withdrawals and, in the case of EUR-denominated MMF, measures taken by the European Central Bank, targeting first the bond market, managed only belatedly to steady the situation.

This should lead, at least in Europe, to a review of the regulation and supervision of MMF and to find ways of enhancing the liquidity of the underlying money market, as well as to a clarification of the central bank's role with regard to these funds that are considered as monetary financial institutions. At the same time, we must maintain the needs MMF fulfil: for an investor, holding a better yielding and safer liquid asset (more diversified than a straight bank deposit); for a financed entity, finding cheaper and more flexible funding via the short-term market as opposed to bank credit; for the bond market, smoothing its functioning by offering counterparties for long-end securities nearing to maturity.

Policy options currently considered are diverse and some of them very extreme; we should find the right balance in our regulatory stance in order to increase the robustness of MMFs without losing sight of their beneficial purpose.