Money market funds are a major source of funding for the short-term economy

Money markets are an important part of the short-term financing of the economy. As such, they are one of the pillars of the financial system. Money market funds play an important role in this market, matching investments with short-term financing needs and offering a return in line with the money markets.

In France, money market funds have been providing sustainable financing for the short-term segment of the economy for over 40 years (since 1981). They are highly regulated in Europe mainly by Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds (MMFRs) since 2017.

Monetary funds and conclusions of the analysis of the recent health crisis

The main conclusion of the Covid-19 pandemic crisis episode of March 2020 concerning French VNAVs stems from two points:

1- Unlike the 2008 episode, no problems were reported in terms of portfolio composition, particularly in terms of asset quality; the funds were sound and resilient in their construction and composition. This is attributable to the MMFRs, particularly to the provisions relating to the authorised management universe for these products.

2- Exogenous shock on the money markets: as the Covid-19 health crisis took on a global dimension in March affecting both the real economy and the financial markets, money markets suffered a sudden series of brutal imbalances where

- Many companies withdrew their money (from lines of credit, deposits and money market funds) to cope with the sudden drop in income from their activities as a result of the near halt of economic activity triggered by the pandemic and the widespread implementation of lockdown policies;
- As a result, money market funds stopped buying money market instruments and sought offers from the banking system to buy back some of their assets in order to rebuild their liquidity reserves;
- Promptly, banks, already under heavy pressure from financing requests from their corporate customers - were no longer able, or willing, to absorb these flows, thus concentrating the liquidity stress, in a context that worsened as the end of the quarter approached.

Solutions include money markets and bank ratios

Each crisis is different, and it is the resilience of the functioning of monetary markets that should be the priority of upcoming work and actions. Moreover, the lessons and experience gained during the crisis mean that the systems are now in place at the Banque de France to better manage the liquidity of the underlying market. This is not an insignificant point, given that until 2020, and still today, only bonds were the subject of massive purchases by central banks as part of the quantitative easing that has been underway for almost a decade. The money market has therefore only been purchased by central banks for a very short period, compared with its bond counterpart.

Money market funds invest massively in commercial paper (CP) and other short-term bank securities. At the end of February 2020, 47.9% of the banking exposure of French money market funds was to French banks. According to the AMF study "*Detailed analysis of the portfolios of French money market funds during the COVID-19 crisis of early 2020*","*Before the crisis, securities issued by commercial banks accounted for almost 50% of the total assets of French MMFs, with 179.9 billion euros at the end of February 2020. One month later, French MMFs 'held only €134.9 billion in bank securities, i.e. €44.9 billion less. In relative terms, bank securities represented only 41.8% of the total 'securities + cash', i.e. 6.2 percentage points less'.*

In times of crisis, the market trading level in short-term bank securities is an important source of liquidity, making it possible to meet redemption requests from customers redeeming their shares in money market funds. It is therefore useful to analyse the incentives that enable banks to play a stabilising role in times of liquidity tension on the markets. Are they able to buy back their own paper (and possibly paper issued by other banks) and, if not, what are the obstacles?

During the crisis, one of the challenges identified was related to the compliance with banking ratios. It proved useful to be able to ease these ratios at certain times during the crisis to facilitate market activity.

Regarding relations with banks during the crisis, the AMF reported[1] that *"some asset management companies have told the AMF that banks have mainly stimulated the market for securities with maturities of less than one month, insofar as these securities do not penalise their regulatory LCR (Liquidity Coverage Ratio[2])".*

As part of the monetary measures taken by the ECB on 12 March 2020[3], the ECB announced a relaxation of the requirements for the short-term liquidity ratio (Liquidity Coverage Ratio, LCR, regulatory threshold of 100% in normal times). Indeed, when money market funds and other investors stop buying bank CP and banks' cash outflows due to customers' generalised need for liquidity increase,

---

[1] https://www.amf-france.org/sites/institutionnel/files/private/2021-05/etude-portefeuilles-mmf-publiee.pdf

[2] The short-term liquidity ratio (LCR) requires banks to hold a certain amount of liquid assets to cover net cash outflows for at least 30 days.

$$\frac{\text{Encours d'actifs liquides de haute qualité}}{\text{Sorties nettes de trésorerie sur les 30 jours suivants}} \geq 100\ \%$$

Outstanding high quality liquid assets must be at least equal to net cash outflows during the 30 days following the date on which the ratio is calculated.
By complying with this ratio, the institution should have sufficient liquidity despite refinancing difficulties on the markets.

[3] https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2668~3f5a65348b.en.pdf

https://economic-research.bnpparibas.com/pdf/fr-FR/Covid-19-mesures-prises-banques-centrales-gouvernements-institutions-internationales-14/04/2020,38876 compliance with the LCR becomes complicated[4]. According to the 2013 Basel recommendations, a bank that uses this option in a context of stress must inform the supervisor and submit a plan to restore its LCR to 100%. On average, the LCR of banks supervised by the SSM stood at 145.6% in the third quarter of 2019.

VNAV money market funds operate like any other investment fund in third-party management: their liquidity is, in fact, reflected by that of the underlying markets. The smooth functioning of the CP banking market is therefore essential for managing the liquidity of money market funds under the right conditions. The AMF study shows that *"the reduction in the net assets of French MMFs has had a particularly marked impact on French banks... for the main French banks, the withdrawal from MMFs represented around 40% of securities held at the end of February*".

It is the restart of repurchasing bank securities by the issuers themselves that helps restore liquidity to the system. This, in turn, enables money market funds, now replenished with liquidity, to buy bank paper again, allowing banks to refinance in the short term and restore their ratios.

The AMF notes that *"...the reduction in the holding of securities by an MMF does not necessarily reflect a specific fear about the issuer, but rather, in a case of stress such as the one at the end of March 2020, an ability to sell the securities. Many banks agreed to play the game and stimulated the secondary market in certificates of deposit by buying back their own issues from those who wanted to sell them.*

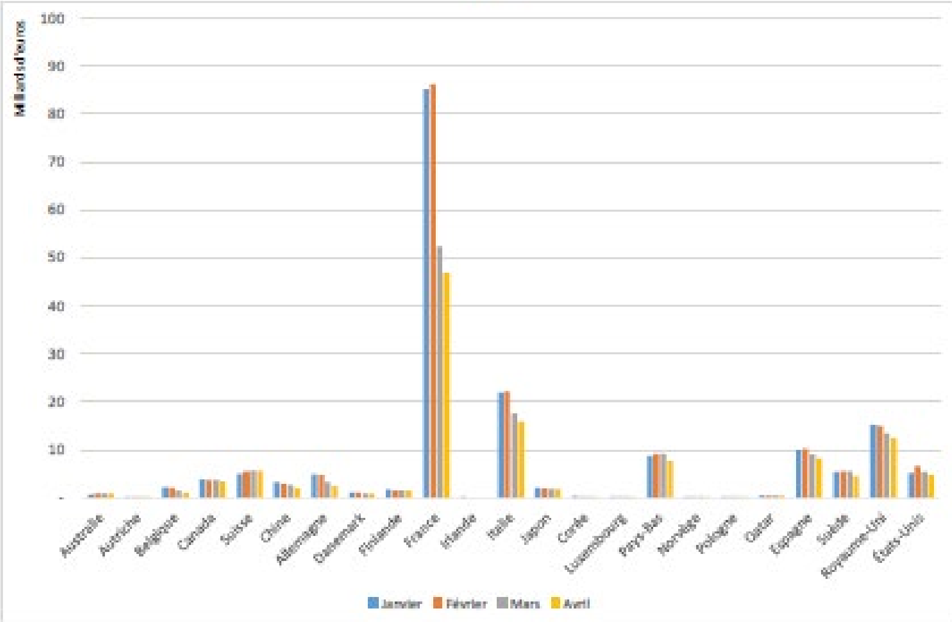
Some were also able to intervene in the securities of other banks, with the intention of bringing them to the ECB's refinancing window. It is highly probable that the different percentages simply indicate the degree of activity on the secondary market of the various French banks."

[4]"With the market swiftly rotating into a "risk-off" mode and given investors' sudden preferences for cash, banks' corporate clients soon began drawing funds from their revolving credit facilities to meet short-term liabilities and other contingent funding needs. This exacerbated the abnormal cash demands being imposed on all banks, at a moment when they could also no longer meet their funding needs by issuing shorter-term instruments, especially commercial paper."

"At the same time, dealer banks' availability to act as market-makers in supporting money market liquidity - often by buying back CP and time deposits/CDs from MMFs - began to dwindle in the face of rising balance sheet constraints."

(Efama Market Insights October 2020 https://www.efama.org/sites/default/files/files/20%2010%20Market%20Insights%20Issue2%20MMFs%20in%20Europe%20final.pdf)

Graphique 10 – Évolution de la composition de l'actif net des MMF français – titres bancaires, par nationalité de la maison mère



Source : Banque de France (Base OPC-Titres, Base OPC-Bilan), calculs AMF

AFG's recommendations for further work

Suggestions regarding banks

AFG suggests to consider implementing facilitating measures at bank level, such as :

- introducing an incentive for banks to take back the CP they issue at market conditions, in the event of a deteriorated market and by decision in coordination with the authorities;

- allowing on an exceptional and case-by-case basis, a waiver of the LCR if market liquidity is considered to be sufficiently compromised..

Suggestions regarding the European Central Bank

The AFG highlights other proposed additional measures to better manage liquidity in times of crisis. Access to the Central Bank in the event of a crisis requires intermediation by banks - such as the corporate securities buyback programmes by Eurosystem central banks (ECB PEPP / CSPP); the Banque de France was very active, which was not the case for all central banks, when it came to offering prices to money market intermediaries (brokers) approached by French funds; the central banks did not seek to determine on behalf of whom the brokers were depositing the securities, making it impossible to know the demand represented by the money market funds, whereas the Fed's MMFLF program specifically anticipated that banks would provide securities on behalf of money market funds.

It will therefore be useful to:

- track on behalf of whom the securities are being deposited.
- study the possibility of reserving part of the programme for money market funds;

- allow greater flexibility in the ECB's programmes (late effective implementation of the PEPP; too much inertia in the programme when the market returns to buying and the aim is to restore the role of the natural players in the sector, i.e. money market funds - to avoid the crowding-out effect; greater flexibility also makes it easier to match the longer-term needs of issuers with the investments of money market funds in uncertain market situations);
- and possibly study the possibility of an ECB facility for reverse repos, as suggested in the European Commission's July 2023 report[5] on money market funds, which mentions the Overnight Reverse Repo Facility (ON RRP) in the US. US money market funds are suppliers of liquidity under this Fed facility against Treasuries as collateral at an agreed rate, very often higher than the rate for tri-party repos (repos with the market). It would be interesting to have such a programme with the ECB because it would avoid using instruments with rates below deposit rates and in situations where banks do not want liquidity from money market funds. The European Commission states:
    - "*In principle, this contagion dynamic would be avoided if MMFs could invest their cash in instruments for which a rapid withdrawal would not lead to market contagion. One instrument that satisfies this requirement would be a deposit at the central bank itself. A case study of such an arrangement can be found in the US, where MMFs may place their excess cash with the US Federal Reserve's overnight reserve repo (ON RRP) facility. In addition to preventing contagion dynamics in situations of liquidity crunch, this facility also puts the US MMF sector at an advantage compared to EU MMFs in terms of flexibility in managing their liquidity inflows." "The decision about opening such a liquidity facility to MMFs however is beyond the competencies of the European Commission and lies in the ECB remit.*"

[5] Report to the European Parliament and the Council on the functioning of Regulation (EU) 2017/1131 on money market funds (the MMF Regulation)
https://finance.ec.europa.eu/document/download/26bd5442-fe36-436d-a11b-82857953d170_en?filename=230720-report-money-market-funds_en.pdf