THE REGULATOR AND LIQUIDITY

POST-FINANCIAL CRISIS REGULATION HAS HELPED MONEY MARKET FUNDS INCREASE THEIR ABILITY TO MEET LIQUIDITY NEEDS, ESPECIALLY IN STRESSED MARKETS. THE RULES CONTINUE TO DEVELOP, AS ROBERT O'RIORDAN EXPLAINS

The financial crisis showed that money market funds (MMFs) could become vulnerable in stressed market conditions, especially when faced with large redemptions. Since then, however, regulators have globally put regulations in place to help MMFs manage their liquidity needs, enabling them to better position themselves to meet investor redemptions during periods of financial instability.

In this paper, we explore some of the main regulatory rules on liquidity – this includes some of the new changes from the EU MMF regulation published on 30 June 2017, which effectively goes live for existing funds on 21 January 2019. The new rules include the use of repurchase agreements (repos) as a risk management technique. We reveal how they can be applied in practice and which types of MMF are placed to take the greatest advantage of the regulation.

Liquidity management in MMFs

Post-financial crisis, regulations have strengthened MMFs' liquidity management toolkits, helping them to better manage cash flows and meet investor redemptions in stressed market environments. Here, we list three key liquidity management tools:

- *Liquidity buffers*
  One of the crucial measures that were introduced to enhance MMFs' liquidity profiles after the financial crisis includes minimum liquidity requirements. Public debt constant NAV (CNAV) MMFs and low volatility NAV (LVNAV) MMFs are required to have a minimum 10% of NAV held in daily maturing assets and a minimum 30% of NAV held in instruments that mature within a week. Portfolio managers will look to increase the liquidity levels above the required weekly buffer in order to avoid mechanistic triggers on redemption gates and/or fees. These triggers, as outlined by the regulations, are based on weekly liquidity levels (see Figure 1, below).

  Daily liquid assets comprise cash, and daily maturing assets, including overnight reverse repurchase agreements (reverse repos) and overnight deposits. Weekly liquid assets comprise weekly maturing assets, including reverse repos maturing within five business days, deposits maturing within five business days, and certain government and government-backed assets. Liquidity buffers should give MMFs enough headroom to prevent the triggering of redemption gates and fees.
- *Stress testing*
  Regulation also requires MMFs to regularly (at least twice a year) conduct stress testing for different possible scenarios. The tests should seek to identify possible events or future changes in economic conditions that could negatively impact the MMF. The tests also need to take into account certain hypothetical factors, such as changes in liquidity levels, credit risk, interest or exchange rates and redemption levels.
- *Repurchase agreements (repos)*
  One of the upcoming changes of the recent regulation is that all MMFs can use repos to raise cash for liquidity management purposes. Therefore, if a surge in redemptions occurred and additional cash was required beyond the 10% of daily liquidity and 30% of weekly liquidity buffers, the repo market can now act as a backstop to allow MMFs to access additional cash before having to trigger redemption

FIGURE 1: REDEMPTION GATES AND FEES

PREVIOUS ARRANGEMENTS	UNDER NEW REGULATION
• UCITS directive has provision for gating redemptions **If net daily redemptions exceed 10%:** • Prospectuses allow the board of directors to apply redemption gates	**If weekly liquidity falls below 30% of the fund value and net daily redemptions exceed 10%, the fund board has the option to:** • apply liquidity fees on redemptions; • apply redemption gates, which limit daily redemptions to 10% of total number of shares for up to 15 days; • suspend redemptions for up to 15 days; or • take no immediate action. **If weekly liquidity falls below 10% of the fund value, the fund board must:** • apply liquidity fees; and/or • suspend redemptions for up to 15 days.

gates and/or fees. MMFs are allowed to raise cash up to 10% of their assets, and are only able to use these repos for no more than seven working days.

What is a repo?

A repo is a form of short-term borrowing to raise cash. The borrower (the MMF) enters a repo contract (known as a Global Master Repurchase Agreement) with an investor, in which it will sell assets that it owns to the investor as collateral, in return for cash. The MMF agrees to repurchase the assets from the investor at a later date (see Figure 2, below).

The repo market – an additional source of liquidity

The upcoming regulation allows the use of repos to effectively build an additional 10% liquidity buffer. MMFs that have suitable assets, such as government debt that they hold directly, can use a repo transaction to generate additional liquidity. However, in the search for yield, government bond holdings are typically a small component of many MMFs. But if the MMF has suitable assets in their collateral pool, they may sell these in the repo market in return for cash – this process is called rehypothecation.

Which MMFs can benefit from repos?

In periods of market stress, investors typically flock to 'safe haven' assets in search of calmer waters. This 'flight to quality' was demonstrated during the financial crisis and more recent periods of market uncertainty where there has been an increased demand for government debt. Therefore, MMFs holding government debt as collateral are more likely to find demand, enabling them to utilise the regulatory provision to access additional liquidity.

Liquidity versus yield

Government debt MMFs have a large allocation in suitable repo collateral, either directly or via a reverse repo that has been collateralised with government debt. However, traditional government debt MMFs, which face banks as counterparties, generate a yield significantly lower than prime MMFs. This has made them less attractive to investors looking for both liquidity and yield.

Recent innovation in the industry has addressed this issue. Government debt MMFs are able to enter reverse repos directly with non-bank counterparties. A reverse repo is very much like a secured loan where cash investors can secure cash against assets, such as government debt, while receiving interest. Traditionally, banks were the ones supplying the assets used as security, but regulatory pressure on the bank is driving up costs of transacting this type of business. However, investors can enter reverse repos without banks, enabling them to avoid the higher transaction costs imposed by banks, which translates into a yield enhancement.

Non-traditional government MMFs help investors benefit from investing with non-bank counterparties in a more simplified fund structure, allowing them government debt security, daily liquidity and a yield enhancement over traditional government MMFs that transact with banks.

Conclusion

Regulators around the world have put regulations in place to help MMFs better prepare for times of market stress. However, certain MMFs can utilise some of these rules better than others, in particular, the use of repos to manage liquidity. Furthermore, a new breed of government MMFs, which are able to invest predominantly in reverse repos secured exclusively against government debt, with non-bank counterparties, can offer investors both the liquidity and yield they desire.

FIGURE 2: HOW DOES A REPO WORK?

AT THE ONSET:

Money market fund (seller of gilts) → **Gilts as collateral** → **Investor (lender of cash)**

Money market fund (seller of gilts) ← **Cash** ← **Investor (lender of cash)**

AT MATURITY:

Money market fund (seller of gilts) → **Cash + interest** → **Investor (lender of cash)**

Money market fund (seller of gilts) ← **Gilts as collateral** ← **Investor (lender of cash)**

Robert O'Riordan is institutional business development director at Insight Investment

Insight INVESTMENT