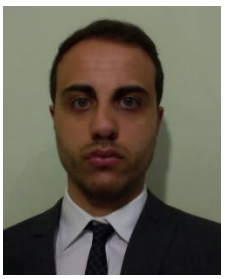
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MMFs and collateralization: An opportunity financial markets should stop missing



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Abstract

Money market funds are a liquidity solution for entities across the globe. Regulatory reforms implemented after the Global Financial Crisis rendered some of them extremely sound, non-volatile and liquid — essentially, high-quality-liquid assets. That should have made their units ideal assets for collateralization. However, this has not materialized in practice. As for their eligibility, policymakers have taken a conflicting stance, depending on whether a central counterparty is involved — a rather erratic approach. Market players are not deploying them for such purpose. Upon closer examination, the primary and most compelling reason for that appears to lie in concerns as to how their units are settled. The rise of tokenization, by creating a new level playing field for settlement of financial instruments, may lead to re-considering such concerns, and finally open the door wide to the use of money market funds as collateral.

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MMFs: function and typologies

Money market funds (MMFs) are a well-known and wide-spread liquidity management solution, combing a store of value component with the provision of income.

In the period leading up to the Global Financial Crisis (GFC), as a result of performing excessive liquidity and maturity transformation — arguably, in a reckless search for yield — they became unable to fulfill their liquidity management function. Investors redemption requests were not met anymore in the terms promised.

As with many other market deficiencies exposed by the GFC, policymakers opted for re-defining the regulatory framework. In the EU, that resulted in the Money Market Funds Regulation (MMFR)[1].

Broadly speaking, MMFR's aim was twofold.

On the one hand, tightening regulatory obligations so as to enhance resiliency and robustness. This was sought mostly by strictly defining eligible assets, with the ultimate view to significantly limit maturity and liquidity transformation.

On the other hand, aligning the degree of maturity and liquidity transformation with the undertakings made vis-à-vis investors and the manner the MMF is marketed. Only MMFs investing exclusively in public debt can promise at par redemption rights, and be marketed as such—the so-called public debt, constant NAV MMFs (PDCNAVMMF). Low volatility MMF (LVMMF), which have a less constrained set of eligible assets, can offer a constant NAV, yet they must disclose to investors that under certain adverse market circumstances they could deviate from the at par redemption. All other MMFs have a much broader array of eligible assets but cannot promise at par redemption to investors.

All in all, the MMFR accomplished its aim, and provided for a category of MMF—i.e., the PDCNAVMMF—which can truly fulfill the pledge of at par redemption. Thus, efficiently perform the store-of-value function, while providing income to investors.

Collateralization: eligible assets' list under EU regulatory framework.

With respect to capital markets transactions — mostly repurchase agreement, securities lending and derivatives — collateralization is a key tool to mitigate counterparty credit risk. The contractual and regulatory framework governing such transactions account for that. On the regulatory side, the European Market Infrastructure Regulation (EMIR)[2] provides for a set of requirements relating to the posting of collateral. Especially, the respective lists of eligible assets which may be posted vis-à-vis a central counterparty (CCP) or in the context of bilateral derivative agreements. Very interestingly, and perhaps surprisingly, these lists do not match.

With regard to collateral to be posted to a CCP, on top of cash, essentially solely investment-grade government bonds are eligible. When it comes to collateral which may be posted under bilateral derivative agreements, the list is much broader: debt securities issued by corporations, equities and units of UCITS are eligible.

The difference is quite significant. What matters the most to our purposes is that the second list comprises units of Undertakings for Collective Investment in Transferable Securities (UCITS)[3]. PDCNAVMMFs — and LVMMF with constant NAV, too — typically qualify as UCITS. That means that from a regulatory perspective they can be used as

[1] Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 of June 2017 on money market funds.
[2] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.
[3] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

collateral in the context of bilateral derivative agreements. Conversely, units of MMFs do not qualify as eligible collateral vis-à-vis CCPs.

Notwithstanding — or rather due to — the above, the reality is that MMF units are very seldom used as collateral in the context of bilateral transactions, be it OTC derivatives, repurchase agreement or securities lending.

Why MMFs are not considered suitable for collateralization purposes?

Analyzing it through the prism of collateral function, one fundamental consideration shall be made. To properly perform it, assets deployed as collateral have to make for a sound store of value. This is why prototypical assets for collateralization purposes are the so-called high-quality, liquid assets (HQLAs) e.g., investment-grade government bonds. Their prominent trait is that they are exposed to a very low degree of volatility and are extremely liquid, so much so that they can keep performing their function also under distressed market conditions. Units of PDCNAVMMF provide for a constant NAV, thus they bring essentially no volatility. They allow for upon request, immediate, at-par redemption, therefore they are extremely liquid. Basically, they can invest solely in government bonds. Put simply: they are HQLAs.

So, where does the hindrance lie?

It is as assessing it through the prism of trading opportunity and settlement that it may be found. MMFs are not dealt on trading venues and have no robust secondary market; there is no CCP involved in the post-trade activity relating to them; they are traditionally not settled through a central security depositary (CSD).

Yet, is that enough to have them not deemed as suitable for performing the collateralization function? The absence of dealing on a trading venue and the lack of a robust secondary market is not a compelling argument: as much as in abstract terms this may impair the liquidity of an asset, in this specific case the redemption rights ascribed to the investors are so thorough to compellingly offset that. What is more, it can be very well held that those distressed market conditions under which redemption rights might not be immediately met are the same under which the market for traditional HQLAs would shrink, too. CCPs are powerful risk mitigation infrastructures; still, their importance is strongly downscaled when the time meant to elapse between trade and settlement is extremely short and the volatility featured by the asset is basically nihil — also: they are not necessarily used for investment-grade government bonds.

The settlement question is where concerns exist. MMFs units are traditionally settled outside the CSD systems, with no DVP mechanism, and lower degree of certainty and standardization relative to other HQLAs in respect of transfer of ownership and creation of security interest.

What could change the status quo and open door to collateralization of MMFs units?

The concerns relating to settlement of those units have existed for a while and might have triggered the discrepancy in terms of assets eligibility described above as well as the unwillingness in the market to post them as collateral. However, the way financial instruments — including units of MMFs — are settled is going through a profound transformation as a result of the advent and rise of distributed ledger technology.

The tokenization of all kinds of financial instruments is providing for a new level playing field with respect to settlement. The latter will be achieved through entries on distributed ledger technology, thereby neutralizing the differences existing nowadays. This is the ideal context for policymakers and market players to move past these concerns and re-consider units of, at least, PDCNAVMMFs as suitable asset for collateralization function—both vis-à-vis CCPs and in bilateral transactions.

Not using MMFs units that qualify as HQLAs for collateralization purposes is an evident missed opportunity for the market. A lack of liquidity's optimization: more HQLAs available means more liquid financial markets.

In the end, a perfect occasion to make up for an opportunity missed for way too long.

About the author

Cristiano Borgogna is a financial regulation lawyer working for Amundi Luxembourg. He holds an LL.M. in finance and previously worked for an international law firm. His expertise ranges from derivatives and market infrastructures, to investment services, funds and digital assets. He is also active at an academic level.

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