COVID-19 and money market liquidity

Challenges, drivers, and the road forward

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Uncertainties around COVID-19 pushed the global equity markets into a tailspin during March. Money market funds, typically a safe haven for investors, took a significant hit as well.

Economic worries spurred a “perfect storm” of events that put substantial pressure on money market funds’ liquidity, with a “bull’s eye” on Prime money market funds. Corporate investors moved assets from prime money market funds to safer government money market funds, while retail investors pulled out cash to cover living expenses. The concurrent oil market collapse prompted massive redemptions by a significant institutional investor. Meanwhile, the drop in the corporate bond market was forcing fund managers to sell commercial paper, government agency debt, and other corporate debt holdings at a loss.

KPMG LLP (KPMG) recently interviewed a number of money market fund managers from leading fund companies to better understand their response to March’s market turmoil and the challenges associated with working in the COVID-19 new reality.

Our interviews showed that no fund company fully anticipated the market volatility—the worst since the financial crisis of 2008. But some were better prepared than others. Most were able to avoid falling below the 30 percent threshold for weekly liquid assets and imposing “fees and gates,” which would have been a black eye to the fund’s reputation. Likewise, most were able to avoid having to tap into an emergency money market mutual fund lending facility set up by the federal government. On top of these pressures, the fund companies had to deal with the same business-continuity issues other sectors were grappling with in response to COVID-19. The most noteworthy of those was having their employees—including customer-service teams supporting shareholder-servicing functions—work remotely and meeting the technology challenges that arose from that migration.

Given the struggles money market funds faced in March 2020, it’s not surprising that some fund companies are starting to think about the commercial viability of and alternatives to prime money market funds. Recently, Northern Trust Corp. announced plans to close a $1.7 billion money market fund that twice this year fell below the 30 percent weekly liquid asset threshold.1 But the more prevalent view is that fund companies will take the lessons learned from these events and look for ways to better monitor economic news, improve analytics, monitor valuations and associated liquidity risk, and implement business-continuity plans.

Here are some of the insights we took away from our discussions with fund managers about their experiences during March and how they plan to move forward in the face of the COVID-19 new reality, which holds out the possibility of a reoccurrence of market volatility in the months ahead.

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March's market turmoil stresses fund liquidity

Flight to quality
With widespread economic uncertainty, the possibility that investors would begin pulling cash from prime money market funds became more likely. A drop below the 30 percent threshold for weekly liquid assets meant funds could impose “fees and gates” — a mechanism to prevent a run on a fund by adding an extra fee for redemptions or suspending redemptions altogether, but also a dint to a fund’s reputation. Corporate treasurers were quick to recognize the possibility of “fees and gates” and, hoping to avoid the extra fees or a halt in redemptions, rapidly moved cash away from prime funds to government money market funds, which are safer and not subject to fees and gates. This realization was the key driver for accelerated outflows from prime money market funds during the middle of March.

Distress in the corporate debt market
Along with the equity market volatility, prices for corporate and commercial paper—typical assets held by money markets—nosedived. Overwhelmed with redemption requests, dealers struggled to make a market in commercial paper, resulting in wide bid-ask spreads—“wide enough for a truck to drive through” as one fund manager described it. The collapsing prices for corporate debt and commercial paper caused valuation and liquidity problems for money market funds and threatened to push their net asset value (NAV) below the $1 threshold—“breaking the buck.” If that were to occur, investors would lose part of their principal and that possibility was another motivation for investors to leave prime money market funds and rotate assets into government money market funds, which are generally viewed as a safer investment.

Investor cash drawdown
With shelter-in-place measures enacted throughout the country, businesses, both large and small, have taken a considerable economic hit. Nonessential employees, who cannot perform their jobs remotely, were suddenly unemployed. Although federal emergency measures have provided some relief, businesses have drawn upon money market funds to fund their operational expenses, while retail investors have pulled cash from money market funds to replace lost salary.

Shock in the oil market
If a global epidemic weren’t enough, March also saw an oil price war between Saudi Arabia and Russia, resulting in the collapse of the oil market. With the price of a barrel of oil falling into negative numbers, a sovereign fund needed cash to offset the loss of oil revenue and made large redemptions from several money market funds.

Money market fund managers respond
Faced with the challenges of these multiple instances of cash withdrawals, money market fund managers needed to increase liquidity—and fast. Here’s how some responded.

Reducing or eliminating management fees: Fund companies quickly waived management fees to add liquidity to support redemption requests. Reports show that the average fee was cut in half, from 30 to 15 basis points (annualized).

Accessing alternative liquidity sources: For a quick injection of capital, some money market funds asked affiliates (for example, the corporate parent) to purchase shares at either market value or at par value. Typically, these purchases would be of “less liquid” securities so the money market fund would have available cash to fulfill redemption requests.

Drawing on the Federal Reserve’s Money Market Fund Loan Facility (MMLF): Recognizing the liquidity challenges facing money market funds, the Federal Reserve created the MMLF. Although many funds had addressed their immediate liquidity by the time the Fed created the loan program, the number of money market funds are now shifting toward accessing the MMLF to obtain a less costly source of liquidity.

Rapidly improving risk and trading analytics: As funds were inundated with redemption requests, prime money market funds were challenged to rapidly improve their portfolio and trading analytics. High volumes of money market fund flows, along with new trading patterns, necessitated the rapid development of new risk analytics, stress testing, cash forecasting, and searches for trading liquidity—often manually.
What does the future hold?
Most funds reported that their operations had stabilized by April. Some mutual fund complexes that manage prime money market funds indicated that they have recovered about half of outflows. They are also increasing their liquidity metrics and shortening the average maturity life of bonds purchased. Nevertheless, the economic instability has fund managers reconsidering practices. Market volatility will most likely continue in the months ahead, and another contraction could likely occur.

Here are some steps money market fund managers can take to help better manage potential threats to liquidity:

**Improve monitoring of economic news:** Watch ahead for social-economic disruptions (closer monitoring for the potential “black swan” events).

**Improve portfolio analytics:** Monitor how bid/ask spreads are trending over time. Watch for any growing disparity between bond bid/ask spreads to indicate market distress.

**Monitor additional security valuations:** Monitor for bond both mark-to-market and mark-to-par; a growing disparity may signal bond market distress and assist with portfolio decision-making. Prepare for the potential of negative money market fund yields, as occurred in Europe.

**Commercial paper agreements:** Adjust commercial paper agreements with sellers to enable improved liquidity (e.g., explore implementation of put/call option rights). Prepare to rapidly apply to the MMLF when needing for fund liquidity.

**Improve liquidity monitoring:** Daily monitor trending liquidity ratings on held securities. Rapidly changing liquidity metrics may signal a potential market crash. Declines of liquidity metrics across an entire asset class or industry may provide an early signal of a “black swan” event.

**Improve investor portals and mobile apps:** Enhance investor facing trading portals to adapt to higher volumes, push-based investor communications, and reporting and analytics.

Conclusion
The market’s “Ides of March” underscores the importance of being prepared for unexpected events. Fund companies had to scramble to meet the unusual number of redemption requests—all the while implementing remote workforce protocols. Fortunately, the market disruption has passed—for now.

Even as businesses are beginning to plan for the COVID-19 new reality, plenty of uncertainty remains. And it isn’t unreasonable to expect another episode of sharp market gyrations soon. Smart fund managers will do more than just be prepared to react quickly. They will have laid out a plan to better anticipate, analyze, and evaluate signals of coming disruptions so they can ensure their liquidity needs are covered.

How KPMG can help
KPMG is ready to help you think through how to navigate the latest challenges brought on by COVID-19-related market volatility.

Our Capital Markets practice has more than 3,500 asset management professionals in the United States, including almost 400 partners. We serve more than 9,000 U.S. mutual funds and 78 percent of the top 50 U.S. money managers.

Our team is equipped with a wide array of tools and capabilities to help you analyze problems and provide solutions across the investment-management value chain. These include economic analytics, investor portal and mobile app development, regulatory gap analysis, accounting advisory services, strategy and operational transformation, data and analytics, technology and data enablement, information technology services management, and change management.

We work collaboratively with our clients, sharing insights and infusing innovation along the way.