

30 November 2018

European Securities and Markets Authority
103 Rue de Grenelle
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France

RE: Consultation Paper on Draft guidelines on stress test scenarios under the MMF Regulation

BlackRock, Inc. (“BlackRock”) is one of the world’s leading asset and risk management firms¹, and is a global leader in the cash management business. In Europe, we manage over €100 billion in cash portfolios on behalf of a wide range of companies and other investors.

We are pleased to have the opportunity to comment on ESMA’s Consultation Paper (CP) on the draft guidelines on stress test scenarios under the MMFR.

BlackRock is supportive of ESMA’s efforts to bring additional resiliency to the Money Market Fund (MMF) sector via establishment of reference stress test scenario parameters. This will assist MMF managers in their effort to meet the stress testing requirements set forth in Article 28 of the EU Money Market Fund Regulation (MMFR).

We have engaged with global and European policymakers with regard to stress testing requirements within MMF reform over recent years, and look forward to continuing the dialogue.

Risk management, including stress testing, is a critical function of the overall investment management process. We believe the MMF industry will be more robust as a result of the new stress testing requirements advanced by regulatory reform efforts in both in Europe and the US. We support much of what has been suggested by ESMA in the proposed guidelines in the CP. However, we would like to make some recommendations on both broad as well as specific topics (below).

Please do not hesitate to contact us if we can provide further input, or if you have questions or comments on any elements of BlackRock’s response.

Stress Testing Overview

BlackRock has been conducting daily stress testing of cash management portfolios since 2007, the beginning of the Global Financial Crisis (GFC). Our cash management stress tests are agnostic to both mandate and currency. Every retail and institutional MMF, and all other portfolios and separately managed accounts (SMA) are exposed to the same rigorous stress scenarios, stress parameters, redemption levels and combinations thereof. The risk positioning of each portfolio and a consistently applied redemption methodology will determine the stress test output, which includes the impact on (1) liquidity holdings as required by applicable regulatory requirements, (2) net asset value (NAV), and (3) mark-to-market (MTM) NAV price per share.

BlackRock’s strong risk management culture is manifested in our extensive resources dedicated to continuously managing and monitoring risk, as well as considerable resources dedicated to creating analytics to help our clients better understand risk. For example, members of our Risk & Quantitative Analysis (RQA) group focusing on cash risk management

¹ BlackRock manages assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

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have developed all our proprietary stress test assumptions by analysing historical data and actual transactions. These assumptions include stress shocks, calibrations and methodologies.

In “Annex III – Cost-benefit analysis”, ESMA states that discretion reduces conformity in the application of the stress test provisions. However, we believe that there are benefits to embracing variability under certain circumstances. Fund manager decisions on stress testing assumptions, supported by reasonable and appropriate analyses, can provide a more comprehensive understanding of potential risks than entirely standardised scenarios. This is especially true given the increased homogeneity of MMF holdings post-GFC.

BlackRock encourages ESMA to consider the following:

Section 3.1 – General features of the stress test scenarios of MMF

ESMA expects fund managers to stress the assets of other MMFs in which they hold shares. At issue is the fact that holdings information is generally released with a lag, making it difficult to stress current risk positioning. Additionally, many fund managers use other MMFs as sweeping vehicles for excess cash. The implication is that this excess cash is available same-day or next-day, which mirrors most funds’ redemption policies. BlackRock would urge ESMA to allow fund managers to consider holdings of other MMFs as overnight assets for stress testing purposes.

ESMA also expects fund managers to stress the collateral received in repo, derivative and other collateralised transactions. Again, this is difficult to do because there is a time lag on the availability of collateral information. Fund managers would need to receive collateral information in sufficient time (same day) to include in stress testing. However, tri-party repo collateral is generally not allocated until the end of the business day, making this exercise difficult.

BlackRock asks ESMA to consider that (1) repos generally have overnight terms, (2) are collateralised by government collateral which should rally during credit shocks, and (3) fund managers should have “collateral sufficiency” policies and procedures in place, including policies ensuring collateral received conforms to the terms agreed to in Repo Collateral Schedules. In short, BlackRock suggests only stressing term repos by stress testing their duration.

Section 3.2 – Hypothetical changes in the level of liquidity of the assets held in the portfolio of the MMF

BlackRock agrees with the concept of utilising observed bid-ask spreads and “stress factors” to test market liquidity. We believe there are other types of stress factors outside of asset-class factors MMF managers may want to consider applying. One such example would be “stress factor based” on the level of redemption, where bid-ask spreads across all asset classes widen as redemption levels increase. This makes intuitive sense – as redemption levels increase, this may necessarily indicate higher probability of wider market stress. Using the GFC as an example, BlackRock observed a negative correlation between the market’s demand for liquidity and market liquidity itself – as redemptions grew, liquidity diminished at an accelerating pace.

Another type of stress factor to consider would be one based on historical analysis of actual bid-ask spreads. In fact, the bid-ask spread behavior during stress periods may be mapped to fund managers’ observed redemption activity across their funds. We believe this methodology for stress factor calibration is robust, and well supported by readily available data.

Section 3.3 – Hypothetical changes in the level of credit risk of the assets held in the portfolio of the MMF, including credit events and rating events.

BlackRock agrees that stress testing should include credit spread shocks, including rating events and default analysis. We think it is worth clarifying, however, that interest rate shocks and credit spread shocks should only be applied to an asset’s appropriate duration measure.

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With respect to “stressed credit spreads”, we believe credit events may include, among other things, deterioration in the credit quality of a MMF asset, or subsets of the assets in a MMF.

With respect to simulating the default of a MMF’s two main exposures, we believe that ESMA should consider the following:

MMF’s which invest in credit instruments generally have the majority of their exposure to prudentially-regulated financial institutions. Given the result of post-GFC reforms has been commensurately stronger bank balance sheets, the probability of a simultaneous default of a MMF’s two largest exposures may not provide optimal information content. BlackRock believes that a default of any one issuer would necessarily have a large deleterious impact on a MMF and is sufficient for this stress test.

Section 3.4 – Hypothetical movements of the interest rates and exchange rates. Hypothetical widening or narrowing of spreads among indices to which interest rate of portfolio securities are tied.

BlackRock agrees that interest rates and credit spreads should be tested – these are fundamental stress scenarios. With respect to the movements of interest rates and exchange rates, ESMA should consider the behavior of financial instruments in the marketplace which act as the mechanisms for quantifying how exchange rate policy impacts interest rate policy and vice versa between two countries.

With respect to credit spread widening stress scenarios, BlackRock suggests applying the same levels of interest rate shocks to credit spread widening shocks. There are many instances when credit spreads widen as interest rates rise, especially when monetary authorities are tightening official policy rates. As these rates rise, unsecured funding levels generally rise, albeit not necessarily contemporaneously.

Section 3.5 – Hypothetical levels of redemption

BlackRock agrees there should be liquidity stress testing, especially given the level of redemptions during episodes of global stress since the GFC. We also would encourage ESMA to consider another option for liquidity stress testing, one which has elements of ESMA’s two suggested options, “reverse liquidity stress test” and “weekly liquidity stress test”.

A combination of elements from the two current suggested stress tests may take the following form: (1) assume redemptions are met with a “vertical slice” of the appropriate regulatory weekly liquidity definitions, (2) calibrate a “stress redemption” by testing a fund’s observed flow volatility, and (3) apply stresses instantaneously, reflecting funds’ same-day/next-day redemption policies.

Creating an instantaneous shock scenario mitigates the need for applying “Credit Quality Steps” (CQS). A MMF’s percentage of weekly liquidity may be based on current market pricing as opposed to amortised cost (current market pricing is used to calculate a fund’s MTM NAV per share). The total -market value of assets qualifying for regulatory defined weekly liquidity would therefore incorporate any liquidity discounts.

Section 3.6 – Hypothetical macro systemic shocks affecting the economy as a whole

BlackRock agrees with introducing multivariate stress shock scenarios. However, we ask ESMA to consider allowing fund managers to switch the sequencing of introducing shocks and redemptions. There are several historical events – for example, the GFC, or the European sovereign debt crises – in which wider market events led to MMF redemptions. MMF investors have proven to be risk averse when their capital and liquidity are at risk.