EFAMA
European Fund and Asset Management Association

RESPONSE

Brussels, 8 March 2024

EFAMA RESPONSE TO UK FCA CP (CP23/28) ON UPDATING THE REGIME FOR MONEY MARKET FUNDS

Preliminary considerations.

As the voice of the European asset management industry, EFAMA is grateful for the opportunity to respond selectively to only a few of the defining questions in this important consultation for the UK's own money market fund regime reform.

Mindful of the considerable number of sterling-based MMFs authorised in the EU and sold to UK investors, as also recognised in the consultation, we make the following preliminary considerations:

- We commend the choice of the FCA to not consult on several of the policy options previously considered by international standard-setters, as well as by EU authorities (e.g. ESRB, ESMA, et al.). In particular, we welcome the fact that the FCA has questioned some of their underlying assumptions in light of market data and mindful of some "hard" market realities. We are, moreover, particularly pleased that the FCA has recognised investors' continued confidence in the LVNAV structure, as well as the value of other existing rules proper to the EU MMFR framework, as for instance, the importance of the "know your customer" requirements;
- While fundamentally agreeing on the need to definitely remove the existing link between liquidity breaches and the potential activation of LMTs for stable NAV MMFs, we express significant reservations with the proposed enhancements to the existing liquidity ratios across all types of MMF structures, particularly where the BoE's calibration has not considered the likely effects deriving from the "de-linking" proposal. In our answer to the relevant question further below, we elaborate on the consequences of a significantly higher 50% WLA requirement, spelling less yield for MMF investors, with returns equivalent to bank deposits, but at a considerably higher cost. This we expect will lead corporate clients and other institutional investors to "internalise" their liquidity management away from a well-regulated and transparent product that is the MMF. We also maintain that the existing DLA thresholds should not be changed;
- For VNAV MMF fund types (both short-term and standard), we believe that the existing EU MMFR calibrations for their respective liquidity ratios (i.e. 7.5% in DLA and 15% in WLA) are sufficient and should not be altered;
- Regarding the proposal to align liquidity thresholds between LVNAV and VNAV funds, we firmly believe this is not justified, especially considering the critical differences between LVNAV and VNAV MMF types. In this regard, we strongly believe that the long-term equilibrium reached under the EU MMFR, where liquidity requirements are mindful of such differences, should be preserved;

- EFAMA encourages the inclusion of MMF units in the definition of acceptable collateral requirements for both non-centrally cleared and also centrally cleared transactions, provided there is sufficient diversification in CCPs' collateral requirements. Naturally, such considerations should be carried out in consultation with MMF counterparties and also involve the clearing ecosystem in view of also amending the relevant regulations around collateral/margining requirements; and finally,
- In line with EFAMA's recent response to the UK FCA's consultation on the Overseas Fund Regime (OFR) and mindful of a future equivalence decision based on the final outcome of the MMF reform in the UK and the EU MMFR, we stress the importance of ensuring that the future distribution of EU MMFs to UK-based investors is not stifled. In this regard, and considering the deep cross-border nature of the European MMF industry, it is of critical importance to preserve the consistency between the future UK and EU frameworks for MMFs. When considering that 90% of sterling-based MMFs are authorised outside of the UK, it is imperative that regulatory divergences be avoided for equivalence to be recognised, so that our industry can continue to serve its clients.

Q2: Do you agree with our proposal to 'delink' stable NAV MMFs' liquidity buffers? Please give your reasons..

EFAMA firmly supports the proposal for stable NAV MMFs to "de-link" any breach of their liquidity requirements from the potential activation of liquidity management tools (LMTs) by their managers. In this regard, we are pleased to see that an overarching consensus between supervisors and industry representatives has emerged globally around the need to remove any unintended threshold effects from existing legislation.

In parallel, we are also pleased that the UK FCA will no longer further consider proposals purporting to improve the resilience of MMFs to market shocks by submitting the activation of LMTs to the approval of supervisors.

Q5: Do you agree with the proposed increases in minimum daily and weekly liquidity to 15% and 50% of assets respectively for all UK MMF types? Please explain your reasoning.

Q6: Do you agree with our assessment of the market impact? Are there other factors we should consider?

Q7: Do you agree with the resulting balance between daily and weekly liquidity requirements? How does the balance between these elements impact resilience?

EFAMA has important reservations in relation to the proposed increases of minimum daily (DLA) and weekly (WLA) liquidity requirements. We set out our arguments as follows and separately for stable NAV and VNAV funds.

For **stable NAV MMF structures**, the increase from the current 10% to 15% in DLA is moderate and could ultimately represent a viable outcome, especially where combined with the removal of the abovementioned regulatory trigger. On the contrary, an increase of the current limit from 30% to 50% in WLA appears excessive and would be largely unjustified. In the experience of stable NAV MMF managers during the March 2020 market correction, we note that no fund – regardless of its base currency - was forced to breach its minimum 30% requirement. In addition, any changes to existing WLA requirements must factor in the significant shift in investors' incentives to redeem, as brought about by a consensual willingness to de-link regulatory breaches from the potential activation of liquidity management tools for stable NAV MMFs. In other terms, considering the definitive removal of potential threshold effects stemming from the abovementioned link, the proposed WLA requirements - which are considerably above the existing ones –

appear disproportionate and unnecessary. In the brevity of Annex 4 of the CP explaining the BoEs modelling exercise, such considerations are not acknowledged. Instead, the conclusion would be that "WLA levels in the region of 50-60%" would be appropriate to guarantee financial stability. We strongly question the BoEs analysis, especially as it is seemingly predicated on "the risk that the failure of a single fund could lead to wider concerns or confidence effects in the sector more widely"[1]. We note in this regard that a "single fund" cannot be representative of an entire industry and would call for the WLA requirements to be calibrated on an industry average, or alternatively, a median instead. Equally, important nuances linked to funds' underlying currencies have not been studied.

Of relevance, we believe, is also the fact that the BoE's calibration is overly dependent on two exceptional historical outflows stemming from two abnormal exogenous shocks, whereas more careful consideration should be given to markets functioning under "normal times" and to which DLA/WLA requirements are appropriate over the long-term for funds to comfortably meet their clients' quarter/year-end cash needs. Considered together, and factoring in the definitive removal of the existing link between breaches to liquidity requirements and the potential activation of LMTs for stable NAV funds, these elements would certainly lead to a more objective liquidity calibration for UK-domiciled MMFs.

We would also argue against a steep increase in WLA requirements LVNAV on the basis of the BoE's own admission, i.e. that "DLA, which is generally used to meet daily redemption, of 15% or greater, would be sufficient to meet the largest daily redemption seen by sterling MMFs in the dash for cash". This would logically imply that a DLA of 15% - which EFAMA believes should in any case be lower – would already count as a significant buffer to meet a first wave of outflows, and thereby reduce the need for an overly conservative 50% WLA requirement. An accompanying consideration is also that the bulk of WLA is *de facto* already made up of DLA (e.g. overnight deposits and reverse repo) and therefore, practically, a fund would hold DLA-quality assets well in excess of the 15% that the BoE deems sufficient. With an increased WLA of 50%, LVNAV funds would have to hold more overnight cash than necessary to the detriment of diversification and of some performance.

Furthermore, by fixing an overly conservative WLA requirement, the FCA's proposals would remove much of the flexibility allowing MMF managers to manage constraints around quarter/year-end by occasionally dipping below their liquidity *minima*. The opportunity given to managers to occasionally do precisely this at times of stress must be considered as another resilience feature of the existing rules, provided that naturally such *minima* are promptly replenished. Lastly, the arguments put forward as to why existing DLA/WLA requirements would deserve to be increased contrasts with two important facts: (i) that no European MMF breached its regulatory *minima* at the height of the two recent market corrections referenced in the FCA's CP; and (ii) that neither MMFs, nor their underlying commercial paper market, became the explicit target of European central banks' (ECB and BoE) market interventions[2].

Of concern is also that the BoE's modelling discards the possibility for MMFs to meet redemptions by selling assets. While it is generally true that MMFs do hold assets to maturity and do rely on DLA to meet initial redemptions, our members' experience from the management of VNAV MMFs suggests that asset sales can and do take place even under challenging market circumstances in order to absorb redemption pressures. The proposed alignment between stable NAV and VNAV requirements are therefore in our view not at all justified. In light of the critical difference between stable vs. variable NAV valuation methods, we believe that such "one-size-fit-all" approach in the calibration of liquidity requirements – for both DLA and WLA - should thus be reconsidered. Supporting this conclusion is also the desire of the European MMF

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[1] Please refer to paragraph 6 of Annex 4 of the CP.
[2] On the limited impact of central bank interventions in Europe, please refer to Section III of EFAMA's November 2020 Report *European MMFs in the Covid-19 market turmoil: Evidence, experience and tentative considerations around eventual future reforms*; available a the following link.

industry as a whole to maintain a fundamental alignment between a revised regime for UK-based MMFs and the EU MMFR framework.

In sum, a disproportionate increase in the WLA requirement to 50% for LVNAVs would likely have the following results:

- Make such MMF structures no longer attractive, and thereby resemble bank deposits for investors to manage their cash holdings. An important source of investment diversification would also be lost, further increasing investors' dependence on forms of traditional bank intermediation, with the consequent concentration of credit risk; and
- Consequently, investors would inevitably have to rely on lower-yielding bank deposits, or on other committed credit facilities offered by traditional banks, as venues to store their cash or meet their short-term funding needs. We question whether this is a desirable outcome from a bank's perspective, as such an eventuality – as a direct result of the proposed reforms - would also imply an increase in their corresponding capital ratios for the provision of overnight/short-term funding.

Regarding **VNAV MMF structures** (both short-term and standard) in particular, EFAMA is firmly against the proposed changes to the existing DLA and WLA ratios. These have proven to work well during recent episodes of market stress and can also be used countercyclically by managers. Moreover, our above considerations against the proposed increase up to 50% in WLA hold true for VNAV structures as well.

Absent further details of the BoE's modelling exercise, our view is that the calibration of liquidity requirements – and of WLA in particular – remains imperfect and would lead to poor regulatory outcomes for the UK, and potentially also affect equivalence with the EU MMFR regime.

Q8: Do you agree that the stable NAV MMF WLA derogation (to include highly liquid government debt as WLA up to a limit of 17.5 % of total assets) should be extended to VNAVs? Do you have views on what public sector debt should be permitted in this derogation, and what the appropriate level should be?

Consistently with the need to preserve existing exemptions in the calculation of a fund's WLA, we also do not agree with the proposal to remove the possibility for (VNAV) MMFs to invest in other MMF unit holdings (please see our answer to Q9 below).

We view the existing derogations to stable NAV WLA requirements favorably and believe they should indeed be extended to VNAV MMFs. In parallel, we recommend the removal of the largely arbitrary 17.5% cap on high-quality government debt (with maturities up to 190 days) that can count as WLA. By allowing MMFs to invest in slightly longer-dated public debt and have this qualify as WLA, the FCA should however recognise that government debt – with the notable exception of public debt CNAV funds – is often not a significant component of MMF portfolios. From their experience, our members have observed that there is no evidence to conclude that liquidity and maturity are dependent. As the CP also notes, "(…) high-quality government/public sector debt instruments are in general likely to remain liquid in most stresses", thereby highlighting that issuer quality (e.g. at least A- from S&P, or A3 from Moody's) is a better indicator than maturity when it comes to public debt instruments. Government debt should also not be assumed to always be liquid by default, as demonstrated already on a few occasions by Eurozone sovereigns over the last decade, as well as exceptionally by the U.S. Treasury market over a short period at the height of the March 2020 market correction.

Finally, as to the proposal to lengthen the termination notice period for reverse repo transactions, from the current two to five business days, we certainly welcome it, adding that five business days is already amply sufficient for an MMF to sell any of its holdings.

Q9: Do you agree that the WLA derogation allowing VNAV MMFs to include money market instruments or units of other MMFs within their WLA up to a limit of 7.5 % of total assets should be removed?

No, we do not agree with the removal of the derogation allowing VNAV MMFs to invest up to a maximum of 7.5% of their total assets in units of other MMFs. Based on the experience of VNAV managers, MMF units were sellable at T+0 during all the recent episodes of market stress. With liquidity being in high demand around these times, disposing of MMF units to raise additional cash has proven viable, with transactions being executed well within five business days. In sum, when it comes to determining the composition of a VNAV fund's WLA, the main discriminating factor should ultimately be which assets are sellable within five business days, rather than their nature *per se* (i.e. MMF units or not). Such conclusion would also be reinforced by the FCA's later considerations in the CP on whether MMF units could be posted and accepted as collateral for non-centrally cleared transactions (please see our response to Q17 below).

Q10: Do you agree with our proposed rules changes to strengthen and broaden the existing MMFR KYC requirements for managers of all MMFs?

EFAMA would second the FCA's proposal for greater client transparency, allowing MMF managers to further refine their preparedness in terms of meeting redemption demands. From our analysis of the March 2020 market episode, we draw important conclusions from there being the "know your customer" provisions under Article 27 of the EU MMFR[3]. In fact, such requirement has proven instrumental in allowing managers to anticipate heavy seasonal quarter-end withdrawals from their corporate clients (as for instance, from institutional corporates based on their quarter-end accounting needs, or pension funds with need to meet regular pay-outs to scheme holders), and thereby enter the March 2020 volatility episode with sufficient liquidity at hand. In addition, we highlight the fact that the *ESMA Guidelines on stress test scenarios under the MMF Regulation* – as last updated and published on 19 December 2023 – recommend MMF managers identify investor types and conduct simulations to infer their behaviour (based also on historical redemptions)[4].

While existing requirements, along with the refinements being proposed in the FCA's CP, are both sensible and valuable, we note that they will never offer managers, nor market supervisors, the perfect foresight over investors' behaviour and consequent redemption demands. More specifically, one must recognise that exogenous shocks, as the bursting of the Covid-19 pandemic, or the sudden sharp rise in UK Gilt yields, have all come unexpectedly and have impacted traditional MMF clients in ways previously unforeseen.

Q11: What do you see as the advantages and disadvantages of a commercial borrowing facility for MMF liquidity during a stress? How likely would you be to use such a facility?

We are generally not in favour of such facility, believing that access to commercial borrowing – and thus leverage – would fundamentally alter the nature of the MMF product. Our opinion is also consistent with the explicit ban under the EU MMFR regime (Article 35 thereof) of any form of "external support". At a closer look, we are also sceptical that forms of commercial borrowing to MMFs, whether through unsecured or committed facilities, would be in the interest of the funds and their investors to begin with. While banks may not wish to lend in a particularly stressed market situation and mindful of their accompanying capital charges, funds would be charged with fees for undrawn and drawn amounts. Such fees would constitute a

[3] Please refer to EFAMA's November 2020 Report *European MMFs in the Covid-19 market turmoil: Evidence, experience and tentative considerations around eventual future reforms*.
[4] Please refer to ESMA's Final Report on *Guidelines on stress-test scenarios under the MMF Regulation*, published on 19 December 2023 and available at the following link.

continuous drag on fund performance (especially for the remaining investors) and where the facility's benefits would materialise only in rare and extreme occasions, but not enough to warrant the facility's cost.

Q12: Do you have any comments on our overall policy approach to the issue of passing on the costs of liquidity to redeeming MMF investors?

EFAMA is fundamentally aligned with the UK FCA's proposals in terms of passing on the true cost of liquidity to redeeming investors. Where asset selling can occur for MMFs, the proposal of identifying at least one additional LMT to the fund's suspension appears sensible and is also consistent with the legislative outcome of the soon-to-be-published text of the EU AIFMD/UCITS review. According to the non-official text, managers of MMFs will be required to select only one liquidity management tool from a harmonised list (i.e. under Annex V of the AIFM Directive, points 2 to 7[5]).

As to the type of LMT, we consider that a fixed anti-dilution levy (ADL), or redemption fee, will be preferable, as (i) its activation is rules-based and operationally easier to implement, especially where the fee is fixed and is not affected by pricing anomalies as a result of rapidly deteriorating market conditions; and (ii), it does not affect the viability of stable NAV MMFs. Positive is that these are explicitly included under Annex V of the near-final text of the recently reviewed AIFM Directive.

Lastly, we share the FCA's rationale for discarding the option to introduce a macro-prudential swing pricing mechanism, as per the FSB's own 2021 reform proposals.

Q14: Do you agree with our proposed rules on the enhancing stress testing for stable NAV MMFs?

Q15: Do you agree with our proposed rules on the enhancing operational resilience for stable NAV MMFs?

We would firstly credit the UK FCA for its choice to not consult on the option of removing stable NAV MMFs altogether, thereby recognising the established role these types of MMFs, and particularly LVNAV funds, play by meeting European investors' cash management preferences.

While welcoming the reform proposals, we would however not characterise breaching the 20 bps "collar" for LVNAV funds as a "breakpoint", akin to a potential threshold effect and thus one likely to precipitate redemption demands and further undermine financial stability. We recognise that the 20 bps collar is first and foremost a regulatory requirement and that in principle there would be nothing inherently "risky" about a 20 bps deviation, provided good governance and careful operational planning (involving all required intermediaries in a fund's value chain as well) are in place, as well as a timely and transparent communication with investors. In this regard, and mindful of the governance and escalation procedures already in place, we believe that the FCA proposals aimed at (i) enhancing stress-testing requirements via the indication of new factors, (ii) having proper arrangements, processes and systems in place to manage a move to a floating NAV, as well as (iii) a timely communication strategy in place to accompany investors in the event of such a move, are sensible and important. In short, the potential breach of the 20 bps collar and consequent conversion of the LVNAV fund's valuation to mark-to-market would represent an operational risk at most.

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[5] Please refer to the text of the European Parliament adopted in first reading on the 7 February 2024; available at the following link. We are expecting the publication of the final text in the EU Official Journal to be imminent following this consultation's 8 March 2024 deadline.

Q17: In your view, what are the advantages and disadvantages of investors posting and accepting MMF units as collateral for non-centrally cleared derivatives?

An important driver behind MMF outflows experienced both in March 2020, as well as in the more recent September 2022 LDI event in the UK, was the need for institutional investors to meet sudden spikes in margin requirements *vis-à-vis* their clearing counterparties and CCPs. Sizeable redemptions in order to raise cash to later post as eligible collateral confirmed to be procyclical, as greater demands for margin collateral in turn provoked more investor redemptions out of MMFs. As EFAMA already noted in its November 2020 report, an option worth considering would be to allow investors to directly pledge MMF units to meet their margin requirements *vis-à-vis* their counterparties for non centrally-cleared derivatives, extending the same opportunity *vis-à-vis* CCPs for centrally-cleared ones in the future. Considering this latter option, we believe that CCPs in Europe should be allowed to further diversify their own sources of liquidity by purchasing units of MMFs when constituting their own margin reserve buffers (initial and variation). These should however remain diversified, avoiding that CCPs become forced sellers of MMF units alone in times of market stress. The fact that CCPs already regularly invest in the same underlying money market instruments as MMF portfolios when constituting such buffers offers a strong justification in favour of the above. As a recognised and a well-regulated cash proxy, greater recourse to MMF units promises to further "lubricate" the functioning of the European settlement ecosystem, even as central clearing becomes more established.

Among the main advantages for non centrally-cleared transactions in particular, we note that:

- MMF units would not need to be sold promptly to raise cash, thereby reducing predictable frictions and any procyclical pressures for other intermediaries to buy-back an MMFs' short-dated instruments;
- Issuers of the latter type of instruments (especially banks) could continue to rely on short-term funding without the risk of seeing this evaporate; and
- Increase the amount of available collateral/margin for all market actors, thereby contributing to greater financial resilience.

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ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages EUR 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the EFAMA Fact Book.

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