THE
INVESTMENT
ASSOCIATION

FCA and Bank of England DP22/1: Resilience of Money Market Funds

August 2022

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.4 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 44% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

The IA welcomes the opportunity to respond to this consultation. Money Market Funds (MMFs) have a critical role in the real economy, providing both short term funding for the financial and public sectors, and a cash management solution to financial, corporate, charity and local government investors, who do not benefit from the deposit protection schemes generally available to retail savers.

The IA is concerned that the narrative in this discussion paper, as in many publications issued by central authorities on the performance of MMFs during the March 2020 crisis, focuses overly on the structure of MMFs and does not give sufficient consideration to the performance of short term funding markets ("STFMs"). The prevailing assumption appears to be that MMFs came under redemption pressures during the March 2020 crisis, therefore these have systemic vulnerabilities. There is also an excessive focus on the experience of US MMFs in these discussions, and a consequent read across to MMFs in other parts of the world including European and UK MMFs.

The experience in Europe and the UK during March 2020, as reported by our members, was that although a number of MMFs came under pressure, all MMFs regardless of structure were able to meet redemption requests, and no MMFs in breached their minimum liquidity levels, let alone were forced to implement redemption fees, gates or to suspend. They did encounter exceptionally low levels of liquidity in secondary STFMs, in which long-term trends were exacerbated during the crisis period. This points to the need for a more thorough review of the functioning of STFMs, including the participation, transparency and efficiency of these markets, which is largely missing from the discussion paper.

The IA welcomes some of the proposals to strengthen MMFs, in particular the proposal to remove the regulatory links between minimum liquidity thresholds in MMFs and the requirement to consider the imposition of redemption fees, gates or to suspend dealing. This threshold effect was partly observed during the March 2020 crisis, particularly in the

Peter.capper@theia.org

US, where the link is more explicit. However, the IA remains cautious on many of the other proposals made in the discussion paper. In particular, the IA opposes any proposals to remove stable pricing for LVNAV MMFs, or to introduce mandatory notice periods or minimum settlement timescales for MMFs. These are wholly disproportionate, would significantly damage demand for MMFs, and would make the UK MMF regime less competitive than other jurisdictions, noting in particular that mandatory notice periods and minimum settlement timescales are not being considered in EU reforms. The IA also notes that, should the UK authorities believe it necessary to introduce dilution management tools into MMFs, a suite of tools will be needed as a single tool such as swing pricing is unlikely to be suitable for many types of MMF.

Overall, the IA does not believe that significant reform proposals to the existing MMF regime, such as the removal of stable NAV, should be considered until a more comprehensive analysis has been undertaken of the functioning of STFMs.

Responses to questions

Q1: At what point might higher minimum liquid asset requirements start to affect the operation of and demand for MMFs? What impacts might you anticipate?
How would you quantify that effect for different levels of DLA and WLA? For example, at an additional 20 to 40 percentage points for minimum WLA (as applied to both LVNAV and VNAV funds).

As in the case of any regulatory threshold, an MMF will nearly always hold an additional buffer over and above any DLA and WLA minimum levels that are set. For LVNAV MMFs, as chart 6 under 3.26 shows, historically these additional buffer levels have typically been around 10%, but these can and have been increased significantly in anticipation of higher redemptions (eg around quarter ends) or during stressed market conditions. Since the March 2020 Covid crisis, higher buffers have generally been maintained to ensure LVNAV MMFs can maintain minimum DLA and WLA levels in the face of greater market uncertainty, exacerbated in recent months by the Russian invasion of the Ukraine. Similarly, VNAV MMFs will retain buffers to ensure they maintain compliance with regulatory minimums even in the event of unexpected redemptions.

When accounting for the additional buffers that are typically held over the minimum levels, increasing minimum WLA by an additional 20 percentage points would therefore mean that LVNAV MMFs would hold the majority of their assets in WLA. In the case of a 40 percentage point increase, this would mean that nearly the entire fund would be invested in WLA. These levels of liquidity are unlikely to be needed in even the most extreme market conditions.

Similarly for VNAV MMFs, increasing regulatory thresholds would result in these funds holding liquidity levels significantly over what they are likely to need, potentially close to half of their assets if the upper range proposed were to be adopted.

The effect of increasing minimum WLAs to the levels suggested would significantly reduce potential yields that could be achieved for investors in these funds. This would make MMFs much less attractive for these investors, who might instead use deposit accounts, reducing their diversification of counterparty exposure, or invest in higher risk products. Some MMF investors might have the capacity to invest directly in STFMs, but many would not. Even for those with the capacity to invest directly in STFMs, all but the largest would struggle to invest as efficiently, perform the same level of credit analysis and achieve the same risk diversification that they could achieve through investing via a MMF.

Increasing minimum WLAs to the levels suggested would also reduce significantly the levels of new financial paper issuance that MMFs could invest in, thereby depriving the banking sector of a much needed source of short term capital. As this finance is often used by the banking sector to fund its own short term lending, this would impact the real economy.

It is difficult to identify a precise level at which an increase in the minimum DLA and WLA levels that would cause MMFs to cease to be commercially viable. In any case, the IA does not believe that an increase in the minimum WLA is necessary for either LVNAV or VNAV MMFs. The discussion paper also proposes removing the links between a breach of minimum WLAs and consideration of implementing redemption fees, suspensions or gates (in the case of LVNAV MMFs). This will effectively release the existing liquidity buffers in the event of unexpected redemption levels or stressed market, which in practical terms have not been available to MMF managers due to client perceptions of the implications of breaching minimum WLAs. In practice, we expect MMF managers to continue to maintain existing buffer levels over the minimum WLAs to avoid breaching these, but in our view the proposed delinking removes any need to increase minimum WLAs.

Q2: What is your view on the feasibility of a requirement for UK MMFs to only invest in public debt? Do you think such an option would need to permit reverse repurchase agreements secured on public debt to be feasible? How should requirements take into account differences in the liquidity between different types of public sector debt?.

We do not believe a requirement for UK MMFs to only invest in public debt is either feasible or desirable. There already exists a MMF structure that can only invest in public debt – the Public Debt Constant Net Asset Value (CNAV) MMF, the take up for which has been limited in the case of sterling MMFs, and our understanding is that no UK authorised MMFs have adopted this structure. Our members have report significant difficulties in trading UK T-bills at various points in recent months. While we see scope for limited adoption of CNAV MMFs, the short-term sterling public debt markets are simply not deep enough to support the current size of the £400bn+ sterling MMF market.

In addition to this requirement being unfeasible, we do not see this as desirable and believe it will have negative consequences for MMF investors and the UK economy. MMFs are currently large holders in financial short-term paper, particularly financial commercial paper and certificates of deposit. This provides important short-term funding to financial institutions, which they can in turn use to provide funding to the wider economy. For MMF investors, this enables them to secure a competitive yield but more importantly to diversify their counterparty risk. Removing the possibility of MMFs investing in financial paper would remove a vital source of funding for the banking sector as well as reducing choice for MMF investors.

It is also important to note that the majority of sterling MMFs used by UK investors are domiciled in EU member states, particularly Ireland and Luxembourg. Although far reaching reforms have been proposed to the EU MMF Regulation, these do not include forcing all EU MMFs to invest only in public debt. Imposing such a requirement on UK MMFs would make these less competitive against EU MMFs that are marketed in the UK.

While we do not agree with a requirement for UK MMFs to be permitted to only invest in public debt, or indeed having mandatory minimum public debt levels, we do see merit in LVNAV and VNAV MMFs being permitted to hold more public debt as part of their daily and weekly liquidity requirements, alongside financial paper. Currently, public debt securities with residual maturities of up to 190 days can only make up 17.5% of CNAV and LVNAV MMFs weekly maturing assets. Increasing this limit, or removing it altogether, would provide more options to MMF managers looking to build robust portfolios designed to meet the redemption requirements of their investors, and provide more liquidity options.

Ultimately, for any proposals of minimum public debt levels for MMFs to be successful, significant changes to the markets in sterling short-term pubic debt will first be needed, in particular increasing the level of issuance and level of market participation. No introduction of mandatory public debt levels for LVNAV or VNAV MMFs should be considered until such reforms to improve the depth of sterling public short term debt markets have been implemented and proved successful.

Q3: What is your view on the impact of a maximum limit on holdings of private sector assets? For example, a maximum of 40%? How might issuers respond if there was a change in demand for those assets from MMFs?

Similarly to our response in question 2, our view is that such a restriction on UK MMFs would not be feasible or desirable. It would require the majority of UK MMFs investments to be in public debt. As noted, the sterling short term public debt markets are not deep enough to accommodate the demand that would be needed by sterling MMFs to invest substantially in these instruments, particularly if more of these were to be onshored in the future.

We do see benefits for all types of MMFs to be permitted to hold public debt securities alongside private sector assets. However, we recommend that it is left to the discretion of MMF managers to determine what proportion of public versus private assets their MMFs should hold, having regard for the characteristics and investor base of their MMF. Removing barriers such as the 17.5% limit on public securities being used as part of LVNAV MMF’s weekly maturing assets requirements could be considered initially, alongside investigating reforms to improve the depth of sterling short term public debt markets.

Q4: What is your view on the relative benefits and costs of the different types of asset requirements, such as increasing minimum DLA or WLA, requiring minimum public sector debt holdings, or imposing a maximum limit on holdings of CD/CP (or a combination of those measures)? Please consider increased resilience for MMFs in times of financial markets stress as part of your answer. If possible please provide data to support your views.

We question a number of the assertions that have been made in respect of the March 2020 covid crisis, particularly by the international central banking community, that all MMFs showed structural vulnerabilities. While some MMFs experienced redemption pressures and subsequent falls in their DLA and WLA levels, others did not experience such pressures and a number experienced inflows during this period. From anecdotal discussions with members, the experience of each MMF seems to have been determined more by the nature of its investor base than any particular structural features of the MMF. It is notable that Euro denominated VNAV MMFs in France suffered significant net outflows during the Covid crisis, totalling €55.3bn between 12 March and 25 April 2020 according to the Autorite des Marches Financiere (AMF)[1], highlighting that the difficulties faced during this period were not confined to LVNAV MMFs.

Most importantly, we are not aware of any UK authorised MMFs, regardless of structure, that encountered any significant difficulties during the March 2020 Covid crisis. Similarly, although some EU domiciled MMFs faced redemption pressures, no MMF was forced to breach its DLA/WLA requirements to meet redemptions, let alone suspend redemptions or implement gates or redemption fees.

This points overall to MMFs remaining resilient in the face of a huge stress test. We do not believe that a case has been made for significant further reform of MMF structures, though the March 2020 crisis pointed to some beneficial reforms that could be made in respect of removing the links between regulatory thresholds and the requirement for boards to take measures including considering imposing suspension, redemption fees or gates, as noted in our response to Q5. The March 2020 crisis also highlighted weaknesses in the functioning of STFMs, which need to be properly analysed ahead of and addressed alongside any significant reforms to MMF structures.

Q5: Do you agree that the regulatory links discussed in the 'Threshold effects related to liquidity levels' section exacerbate first mover advantage and can drive additional unnecessary investor redemptions in a stress? If so, how much of a problem does it cause and how would you quantify it? Would you support a proposal to remove such links? If possible please provide data to support your views.

There were a number of factors that drove redemptions in the March 2020 covid crisis, not least the sudden demands for investors to draw on liquidity reserves to meet unexpected cash requirements due to the economic effects of sudden lockdowns and increase in margin calls due to heightened market volatility. It is not clear that concerns of MMFs breaching their thresholds was a primary driver of redemptions during the immediate crisis, but nonetheless we agree that the current framework as perceived by investors does have the potential to create threshold effects.

Significantly, there was a perception during the March 2020 crisis that MMFs could not breach their minimum WLA thresholds among both managers and investors. MMFs are required to make portfolio information, including on the maturity breakdown, available to investors weekly, and in practice many MMF managers publish this daily. Institutional and corporate investors are known to monitor portfolio information. MMF managers, aware of this scrutiny, therefore took particular care to maintain DLA and WLA levels to above their thresholds.

The non-Handbook Guidance issues by the FCA, which clarifies that a breach of the minimum WLA thresholds do not require MMF managers to impose fees, gates or suspensions is very welcome. However, we suggest that the FCA should aim to go further and remove any linkage in the regulation to the DLA and WLA thresholds and an explicit requirement for boards to consider implementing these liquidity management tools. This will go further to reassure investors that this minimum liquidity pool is available to meet redemption requests should it be needed without fear that the fund may be suspended if it is automatically drawn upon.

---

[1] https://www.amf-france.org/sites/default/files/private/2021-05/etude-portefeuilles-mmf-publiee-en_1.pdf

In practice, we expect MMF managers to continue to maintain buffers over these minimums and keep their MMFs operating above these minimum levels at all times other than in exceptional circumstances. Nonetheless, delinking would transform the minimum WLA levels into a liquidity reserve that can be used in times of stress, enhancing the resilience of MMFs, rather than a floor that cannot be breached.

Q6: What is your view on whether authorities should approve the activation of liquidity fees or the imposition of gates?

We agree with the views expressed in the Discussion Paper, that managers of MMFs are best placed to decide whether these tools should be activated.

Q7: Do you agree that the usability of liquidity resources could be improved by changes to how they are defined, such as defining requirements as an average over a period, or allowing authorities to change aspects of the requirements in a stress? What other changes should be considered that might make liquidity resources more usable? Which changes might be most effective at making buffers more usable? If possible please provide data to support your views.

The IA is of the view that delinking WLA levels from the requirement for the board to consider imposition of liquidity management tools is the best way to make buffers more useable, as outlined in our response to Q5.

In the absence of delinking, changes to how liquidity resources are defined, or changing aspects of the requirements in a stress are not likely to be as effective as alternative approaches. For example, given the daily publication of portfolio information, changes to temporarily reduce DLA/WLA limits would need to be decided and announced quickly for managers to be able to rely on these. These might still take time to communicate to and be absorbed by investors, limiting the effectiveness of the reduced limit in avoiding threshold effects. Similarly, specifying “average” holding levels might still give rise to potential threshold effects if the investors perceived a likelihood of the average level being breached.

Q8: Under what circumstances do MMF managers consider selling assets to meet redemptions? How might that change as a result of policy options aimed at making liquidity buffers more usable (including policies that aim to reduce threshold effects, and policies that change how liquidity requirements are defined)?

MMF managers, particularly of LVNAV MMFs, will seek to align maturity cycles with investor redemption cycles, particularly at periods when there is typically an increase in redemptions such as quarter ends. As such, assets are normally held to maturity in LVNAV and short-term VNAV MMFs, and either used to meet redemptions or reinvested in new assets.

MMF managers may occasionally seek to sell assets to meet redemptions if they are able to obtain favourable prices for the assets, or if they want to maintain higher levels of liquidity in their MMFs. It is therefore important there is a functioning secondary market available in money market instruments, so managers are able to sell at acceptable prices. Even if in practice most assets are likely to be held to maturity, it is necessary for MMF managers, and their investors, to have confidence in the functioning of the secondary markets to buy primary issuance. The absence of this confidence during and since the March 2020 crisis has resulted in managers increasing their DLA and WLA levels, as shown by chart 6 under paragraph 3.26, effectively “hoarding” liquidity. While this reassures MMF managers and their investors that the MMF will be able to meet redemption requests, this limits the yield potential of the MMF and reduces participation of MMFs in primary issuance for CP and CD, reducing the short-term capital provided to the financial sector, in turn affecting its provision of short term funding to the wider economy.

Making liquidity buffers more usable would help prevent the need for firesales of assets in times of stress. In practice, we expect in most market conditions that MMF managers will want to maintain DLA and WLA levels above thresholds and only draw below these when absolutely needed. The proposals in the discussion paper are therefore not an alternative to analysing and improving the functioning of STFMs.

Q9: Are you aware of any cases in which a sterling MMF uses or has used liquidity fees or swing pricing? If yes, please provide details if possible.

The IA is only aware of limited examples of these tools being used in retail investor VNAV MMFs that offer settlement only on a T+1 or longer basis. In practice, these appear to have been applied very rarely and swings or levies have been small. We are aware that of an MMF that has used dual pricing, although our understanding is that in practice the bid and offer price have generally been set at the same price with no spread applied, ie although the dual price mechanism was used, from an investor perspective it would have appeared to be a single priced fund.

In practice, the dilution affects arising from subscription and redemptions in MMFs are usually minimal in all but the most extreme circumstances. MMFs only hold relatively short term assets that are usually purchased as primary issuance and held to maturity. On occasions where they are sold, prices are normally close to their par value given their short residual maturities and high credit quality. Dilution effects are therefore immaterial in most market conditions and while prospectuses provide for these tools, we understand that for MMFs in practice they are rarely used.

Q10: Do you agree that UK MMF rules should be clear on the need for the manager to avoid material dilution? Please explain your response.

The IA supports the use of anti-dilution tools such as swing pricing, anti-dilution levies and dual pricing for open-ended investment funds where material dilution effects can occur. These are particularly important to protect investors in funds investing in equities, longer-dated fixed income securities and particularly property, where material dilution affects can arise from the purchase and sale of assets. Indeed, the UK was among the earliest jurisdictions to use anti-dilution tools, having their origins in the dual pricing mechanisms historically used by unit trusts. Although primarily tools to protect investors from dilution, these can also in a limited way discourage first movers, thus having a benefit in a liquidity management context.

However, as stated in our response to Q9, these dilution effects do not generally arise in any material way in MMFs in nearly all market conditions. In addition, certain dilution tools are not suitable for many types MMFs which are designed to preserve capital and offer stable prices, particularly to enable same day settlement – swing pricing in particular introduces price volatility, so is not suitable for funds offering a stable NAV.

It is important that MMFs be permitted to choose from a range of tools rather than mandated to use a particular tool. This is in line with the approach recommended by ESMA in its final report to the European Commission[2], which recommended that MMF managers be required to use one of the following: anti-dilution levies, liquidity fees or swing pricing. We recommend a similar choice is provided to MMF managers to select the tool most appropriate for their MMF.

Finally, we note that MMF managers should have discretion when to apply any anti-dilution tools and the circumstances in which it is necessary to apply these. In practice, material dilution effects are not likely to arise in MMFs except possibly in the most stressed market conditions, so these are not tools that we would expect to be deployed in most circumstances.

Q11: Do you think UK rules should be specific on how MMF managers should avoid material dilution in the way their funds are run, for example, with rules and guidance relating to LMTs? Please explain your answer.

We do not believe any level of regulatory prescription or guidance is required for MMF managers in the area of dilution management, beyond the existing requirement for MMF managers to act in the best interests of their investors. As noted in our response to Q9, UK managers are highly experienced in operating anti-dilution tools and determining the circumstances where these should be applied. In practice, the circumstances where material dilution effects may arise on MMFs are likely to be exceptional.

Q12: Do you have any comments on the current MMFR valuation rules in relation to this issue?

We do not believe significant changes are required to article 29 of the MMFR in relation to this issue, given these already require a conservative approach in valuing assets. In article 29(3)(a), an asset valued on a mark-to-market basis must be valued at the more “prudent” side of bid or offer, unless the asset can be closed out at the mid-market price. For an asset valued using mark-to-model, article 29(4)(a) requires the asset to be valued “conservatively”, taking into account the volume and turnover of the asset, the issue size and portion of the issue the manager plans to buy and sell, as well as risk factors associated with the asset. These rules should already ensure that dilution effects are limited in the event assets need to be sold.

Q13: Do you have any comments on the macro-prudential swing pricing option?

We agree with the comments in paragraph 4.48, that the MMF manager should be best placed to make a judgement about use of LMTs such as swing pricing, anti-dilution levies or liquidity fees. Noting that MMFs will have different asset profiles and investor profiles, we consider that macro-prudential swing pricing options could be harmful to many participants, and indeed the possibility of these being applied could result in first mover redemption pressures if some investors were to hear rumours of mandated swings being considered at a macro-prudential level. We believe the UK authorities are taking the correct approach in disregarding this option.

---

[2] ESMA 34/49/347 Final Report on the MMF Review – available via https://www.esma.europa.eu/press-news/esma-news/esma-proposes-reforms-improve-resilience-money-market-funds

Q14: Do you think the investor protection and possible financial stability harms set out for LVNAVs are, or could be material? Please explain and provide evidence, including any relevant data, to support your conclusion on this.

The LVNAV MMF is an essential part of the sterling MMFs marketed in the UK, most of which are domiciled in the EU and exported to the UK. Around 97% of sterling MMFs are LVNAV MMFs, amounting to £249.1bn in September 2020[3].

While it is impossible to eliminate all potential risks of financial stability harms arising from any product, market or service, our view is that the design of the LVNAV MMF structure implemented by the MMFR has ensured there is appropriate robustness around this structure. Importantly, it provides that the LVNAF MMF can only use amortised cost accounting for its valuation and round its price where the NAV calculated on an amortised cost accounting basis is within 20bps of the variable NAV calculated on a mark-to-market or mark-to-model basis. A MMF will need to use a variable price if the 20bps collar is breached. This ensures that redemptions can only be provided on a stable NAV basis where the value of the assets is within a reasonable margin of the realisable values of the assets. This feature is further supported by the high liquidity thresholds that LVNAV MMFs are required to retain.

In our view, a disproportionate attention has been given to MMF structures, particularly to stable NAV MMFs investing in financial paper such as LVNAV MMFs, at the expense of a proper examination of the functioning and efficiency of STFMs. While a number of European MMFs experienced redemption pressures during the March 2020 crisis, these issues were not unique to or even concentrated in any single MMF structure. Many VNAV MMFs experienced redemption pressures along with many LVNAV MMFs, as noted by both ESMA and the AMF. Conversely, our members report other MMFs, including both LVNAV MMFs and VNAV MMFs, that did not come under such redemption pressures. Crucially, all MMFs that came under redemption pressures, regardless of their structures, were able through proper liquidity management practices to successfully manoeuvre through this very difficult period in the markets, pointing to the overall resilience of all MMF structures.

As noted in our responses to Q15, the LVNAV MMF structure is particularly important to UK institutional, corporate, charity and local government investors. While LVNAV MMFs could benefit from some limited reforms, in particular the explicit removal of the linkage between breaching minimum WLA levels and the obligation to consider the imposition of liquidity management tools, overall we do not believe the experience of March 2020 evidences material failures in any of the MMF structures, particularly to the extent of removing crucial product features, such as the ability for LVNAV MMFs to use amortised cost accounting and round prices to two decimal places.

Q15: Do different types of investor (e.g. retail, corporate or financial) value stable NAV offerings differently? What would be the implications for those investors if the stable NAV features of the LVNAV funds were removed?

The availability of a stable NAV MMF that can invest in non-public securities is particularly important for UK corporate and financial investors in sterling MMFs. UK accounting practices allow MMFs with stable prices to be treated as a cash equivalent. The majority of

[3] Source: EFAMA, November 2020 (https://www.efama.org/sites/default/files/files/20%2011%20European%20MMFs%20%20Covid-19%20-%20EFAMA%20Final%20Report%20%28November%202020%29_0.pdf)

UK corporate treasurers therefore prefer stable NAV MMFs over variable NAV MMFs, although both types are available in sterling. These MMFs are also able to facilitate same day liquidity, which is valued by UK institutional clients.

Sterling LVNAV MMFs service a wide range of institutional investors, providing greater diversification of risk and better yields than bank deposits. These include financial services providers, corporate enterprises, charities and local governments. The majority of MMFs offered to UK investors are LVNAV MMFs as this best meets their requirements, ie this is driven by investor demand. Feedback from our members suggest that while some investors, particularly those in the financial services sector, may be willing to switch to VNAV MMFs, the majority are likely to stop using MMFs altogether were the LVNAV MMF structure no longer to be available, or prevented from using amortised cost accounting and rounding of share prices to the nearest percentage point to maintain a stable price.

We are not aware of any LVNAV MMFs that are marketed to individual retail investors. These investors are not impacted by the same accounting requirements as corporates, and do not require the same intraday dealing and settlement features. Retail investors have generally invested in VNAV MMFs. Historically, many of these MMFs were offered as a "cash" option for Maxi ISA investors by asset managers who did not have the appropriate permissions to operate deposit accounts – the Maxi ISA enabled an investor to hold stocks and shares and cash savings within the same ISA. After the Maxi and Mini ISA distinctions were abolished, the need for a product eligible for cash ISA investors diminished and there are fewer of these funds offered, although some platforms continue to offer MMFs to retail investors as an alternative to holding uninvested cash in (normally zero interest) deposits.

Q16: What alternatives are there for MMF users who specifically need capital value preservation? How do the costs and risks of those alternatives compare with MMFs?

In theory some of this market could be serviced by Public Debt CNAV MMFs - there are a small number of Public Debt CNAV MMFs available in sterling. But overall, as noted earlier, our members advise that markets in sterling public debt are simply insufficient to support the demand for stable NAV MMFs in sterling. In addition, while meeting the needs of some investors, sterling Public Debt CNAVs will provide less issuer diversification and lower yields, and therefore will likely be less attractive to most current LVNAV investors.

Another possibility for some investors would be to invest in short term funding markets directly. For most investors, this will be less efficient and more costly, as they will not benefit from pooling, and few investors will have sufficient scale to achieve the same levels of diversification. Moreover, most corporate, charity and local government investors will not want to navigate the complexities of investing directly in money market instruments, in the unlikely event they even have the resources, expertise and facilities to do so. They will more directly be exposed to low liquidity levels in short term funding markets – unlike in a pooled vehicle, where redeeming investors can be netted off against incoming investors, they will have to find willing buyers in the secondary markets themselves. With the exception of the larger financial services providers and largest corporations and institutions, the option to invest directly in short term debt markets will not be a feasible option for most sterling LVNAV MMF investors.

This essentially leaves bank deposits as the most likely alternative for the majority of LVNAV MMF investors. While it may appear a straightforward solution, this will significantly increase their counterparty risk exposure and almost eliminate any diversification. It is far from apparent that this additional business will be welcomed by banks - our members report that banks are increasingly reluctant to offer large deposit accounts to their corporate, charity and local government clients on competitive terms.

Overall, were the LVNAV MMF structure to no longer be available, we anticipate based on member feedback that the impact on providers of sterling MMFs and on investors in those MMFs would be hugely damaging. Moreover, the IA does not believe the case has been made for significant reform or abolition of LVNAV MMFs on the basis of how they performed during the March 2020 crisis. While a number of LVNAV MMFs serving institutional investors came under redemption pressures, this was equally true of VNAV MMFs servicing institutional investors – the majority of redemption pressures were driven by the sudden and unexpected need for liquidity by investors due to the increased market volatility and the economic impact of lockdowns arising from the rapid spread of Covid, rather than anything inherent in the LVNAV structure. Equally, the IA is aware of both LVNAV and VNAV MMFs that did not come under redemption pressures during the March 2020 crisis, and experienced net inflows during this period. In light of this, the IA views proposals to abolish the LVNAV MMF structure as a wholly disproportionate and unsupported policy response to the March 2020 crisis, and strongly recommends that the UK Authorities retain the LVNAV MMF as a structure permitted to use amortised cost accounting and the rounding of share prices to the nearest percentage point to maintain a stable NAV.

Q17: For investors in sterling government MMFs, what was the impact of moving from distributing to accumulating share classes and the associated end of the stable NAV offering? Were there any implications for the accounting treatment of those MMFs? Were there any other costs associated with the change? If possible please provide data to support your views.

The IA does not have any of these funds in its sectors and therefore cannot comment on the impact of these changes.

We would, however, caution any experiences of the impact of negative yields being reflected in stable NAV public debt MMFs through the introduction of accumulation units being applied to proposals to abolish stable pricing in LVNAV MMFs. For investors in the sterling government MMFs, the effect would have been similar to holding cash in a deposit account with a negative interest rate – the change in value arising from the erosion of the balance due to the negative interest rate. These funds could also continue to operate features such as intraday settlement. Our understanding is that this would not have changed the nature of the holding or its treatment from an accounting perspective.

The abolition of the mechanisms that enable LVNAV MMFs to operate a stable NAV would alter the nature of the holding, its accounting treatment and the ability of the fund to offer intraday redemption and settlement. This is not therefore comparable to the scenario of sterling government bond MMFs moving to using accumulation units and it should not be assumed that the impacts of these changes would be comparable.

Q18: If stable NAV was no longer permitted for UK LVNAV MMFs, and assuming no other changes (e.g. to liquidity requirements), what do you expect to happen to demand for LVNAV funds relative to VNAV funds? What value would there be in retaining LVNAV as a UK MMF type?

It is not clear to us that there would be any material benefit to retaining the LVNAV MMF structure if the features that permit it to operate a stable NAV, namely the ability to use amortised cost accounting and rounding of the price to the nearest percentage point, were to be removed. It is possible some investors might derive some additional comfort from the higher minimum DLA and WLA requirements, though it our understanding that it is the stable NAV feature and the ability to offer intraday dealing and settlement that is most attractive to the investors that use these funds, as explained in our response to Q15.

Although they would be subject to lower minimum DLA and WLA requirements, in practice there is nothing preventing short term or standard VNAV MMFs from retaining similar DLA and WLA levels as LVNAV MMFs. It is therefore hard to see there would be a fundamental distinction between an LVNAV MMF that was not permitted to operate a stable NAV and a short term VNAV MMF.

Q19: Should UK public debt CNAV MMFs continue to be permitted to operate with a stable NAV?

The IA is strongly of the view that UK public debt CNAV MMFs should continue to be permitted to operate within a stable NAV within their current rules. Paragraph 4.53 highlights that these funds have proved particularly resilient in times of material stress in markets. Therefore we see no argument to justify the removal of the ability for a public deb CNAV MMF to operate a stable NAV.

Q20: In what way might these three types of liability side policy options (reducing dealing frequency, imposing notice periods, and imposing minimum settlement periods) impact MMFs' ability to meet MMF investor needs? How might investors respond to these options? How might it affect investor liquidity management? What alternative cash management options do investors have, and what costs and risks are associated with the alternatives?

These proposals are likely to be very unattractive to most users of MMFs. Institutional and corporate investors in MMFs value intraday or same day redemption and settlement. In the majority of cases, these cash requirements are cyclical and MMF managers manage their liquidity and asset maturities around periods where investors typically redeem holdings.

The MMFR imposed strict "Know Your Customer" (KYC) requirements on managers of MMFs. While some difficulties in getting the appropriate information on smaller underlying investors remain in the case of intermediated investments (eg through platforms), active client relationships and regular dialogue with larger investors means that managers of MMFs are usually aware in advance of larger client cash needs and able to increase liquidity levels to ensure these requirements can be met. Robust KYC therefore mitigates any need to operate notice periods.

It should also be noted that there is nothing inherently illiquid about the assets that are held by MMFs. Secondary trading in CP and CD is normally low, as these assets are typically held to maturity, but once a sale is agreed, title to these assets and settlement is arranged very quickly. Therefore, there is no fundamental mismatch between the liabilities side of MMFs (dealing and settlement frequency) and the liquidity of underlying assets. Therefore, were dealing frequency to be reduced, notice periods or minimum settlement periods to be introduced, we anticipate these being highly unpopular with investors in LVNAV MMFs and short term MMFs, who are likely to see no justification for these measures. Financial institutional investors, who rely on the availability of intraday dealing and settlement in MMFs in order to meet margin calls and settlement deadline, would be unlikely to use MMFs were notice periods and minimum settlement deadlines to be introduced.

Q21: Which investors value intra-day settlement vs end of day settlement (T+0), T+1 or T+2 day settlement?

As noted, financial, corporate, charity and local government investors, who are by far the largest users of MMFs, all value intraday settlement. We understand this feature is generally less important to retail investors.

Q22: The UK authorities are not aware of any MMFs in non-UK jurisdictions imposing limits on dealing frequency, or having non-zero notice periods, as a matter of general practice. Do you have any information to the contrary?

The IA is not aware of any other jurisdiction imposing these measures.

Q23: Do you agree with our assessment that policy options to increase the liquidity of MMFs' assets could achieve the outcome of reducing MMF liquidity mismatch such that these liability side options may not become necessary?

We do not consider the liability side options suggested in the discussion paper to be necessary to reduce liquidity mismatch, and we consider these proposals likely to be harmful, as stated in our response to Q23. We do not accept there is a fundamental liquidity mismatch between the liquidity of assets held in MMFs and their redemption terms, noting that once a trade is agreed, execution and settlement can proceed very quickly. Rather there are material issues within STFMs that need to be addressed to increase market participation and transparency to ensure that these can operate efficiently.

Q24: Would liquidity-based redemption deferrals introduce the sort of regulatory threshold problems covered in the 'Threshold effects related to liquidity levels' section?

The MMFR already provides for managers of MMFs to impose gates on redemptions (which we broadly understand to be redemption deferrals). We are of the view that it is important that managers of MMFs (as with other types of funds) have at their disposal a suite of liquidity management tools that they can apply where they believe action is necessary to protect investors.

There is a risk of threshold effects with liquidity management tools such as suspension or deferral if the circumstances in which they are to be activated are too closely prescribed, for example, if they are determined in regulation by the size of redemptions or WLA thresholds, or can be imposed centrally by authorities. This gives scope for some investors to monitor the applicable ratios, market actions or interventions of central authorities, and pre-emptively redeem if they believe thresholds will be crossed, creating the possibility of threshold effects. The possibility of threshold effects can be reduced through avoiding linkages to the implementation of liquidity management tools to regulatory requirements, and ensuring the utilisation of these tools is at the discretion of the manager of the MMF to be deployed when it is necessary to protect the interests of investors.

Q25: Is there a way to design liquidity-based redemption deferrals which avoids threshold effects? Would such a design be useful for MMF managers or investors or both?

As noted in our response to Q24, in our view threshold effects arising from deferrals or gating can only be avoided by removing any links between their activation and regulatory thresholds, and allowing the board of the MMF discretion on when to implement these.

Q26: On what occasions has redemption-in-kind been used for MMFs in the past? Under what kind of circumstances or conditions might it be used in the future? What benefits does it provide to investors?

We are not aware of redemption-in-kind being used for MMFs. While we believe redemption-in-kind should continue to be available as a liquidity management tool for managers of UK MMFs, in practice we believe that for MMFs, unlike other fund structures, redemption-in-kind is unlikely to offer material benefits to investors as we explain in our response to Q28.

Q27: What are the current barriers to offering redemption-in-kind to investors, either in normal or in stressed market conditions? How might those barriers be reduced or overcome?

Typically redemption-in-kind is used to facilitate the transfer of an investment from one fund to another fund or to a segregated mandate, minimising transaction costs and time out of the market for the investor, and dilution effects and liquidity pressures arising on the fund. In practice, redemption-in-kind requires advance planning between the parties, and sharing of key information such as identifiers, Crest settlement details, asset sizes, etc, and require both parties to perform reconciliations of all lines. As paragraph 4.66 notes, these typically take several weeks to execute and incur project and administration costs. Redemption-in-kind is therefore a more useful tool for operational changes such as portfolio transfers, rather than as a tool to manage liquidity pressures.

For MMFs, which have a regular turnover of assets, the administration burdens involved in redemption-in-kind are likely to outweigh any benefits, given the number of holdings and relatively short maturities of the assets. Given a redemption-in-kind would take several weeks to plan, this is enough time to allow sufficient assets to mature and pay the redemption in cash without transaction costs being incurred for the investor or dilution arising for the MMF. The redemption could either be planned for a date, or rolling instructions executed over the period.

Moreover, in stressed market conditions, redemption-in-kind cannot be facilitated quickly, noting the usual settlement time for MMFs is short, usually intraday to T+1 depending on the MMF. These also rely on the investor having, or being willing to set up, the appropriate custody accounts to be able to receive the assets. Financial institutions investing in MMFs are likely to have these, but corporate, charity, local government and retail investors are unlikely in most cases to have these. Nor will most MMF investors, with the exception of financial institutions, have the investment expertise or facilities readily available (such as custody arrangements) to manage the assets or the market access to arrange their sales. As such, we envisage there are unlikely to be many scenarios where redemption-in-kind could be used by MMFs in stressed scenarios.

Q28: Do you have any other comments on the use of redemption in kind for MMFs?

As noted in our response to Q26, we believe that redemption-in-kind should continue to be available as a tool for managers of MMFs, although for the reasons given in our responses in Q26 and Q27 we do not expect their use by MMFs to be extensive, particularly in stressed market conditions.

Q29: Do MMF managers effectively manage investor concentration? If you are a manager, how do you monitor investor concentration in practice?

We are aware that managers of MMFs monitor investor concentrations through the KYC requirements and will typically engage regularly with larger investors through their client relationship managers to understand the nature of their business, their regular inflows, cyclical redemption requirements and the type of scenarios that might result in them needing to make further redemptions. The KYC requirements are an important tool for understanding, monitoring and anticipating investor behaviour. This was one of the reasons managers of MMFs were able to meet redemption requests despite the redemption pressures that arose in March 2020 due to the unexpected speed of government lockdowns and the consequent impact on market volatility.

Q30: What is your view on hard limits, or a maximum percentage any one investor (or several investors or investor types) could invest in any one MMF?

The IA does not consider that hard limits should be imposed on individual or several investors/investor types that could invest in one MMF. Such limits are likely to be a blunt instrument, and it is difficult to see how they could be determined except on an arbitrary basis. It is more important that managers are aware of and can anticipate the needs of their larger investors.

From this perspective, although the KYC rules have largely helped managers of MMFs to achieve this objective, these could be further enhanced by a requirement on intermediaries to provide the KYC information that managers require for the purposes of managing liquidity. There is no current requirement within the MMFR obliging intermediaries such as nominee investors and platforms to provide this information. Although COBS 14.4.10R goes some way to requiring intermediate unitholders to provide information to managers for liquidity purposes, this only obliges the intermediary to provide information that the manager “reasonably needs”. The IA suggests this requirement on intermediaries to provide KYC needed for liquidity purposes could be strengthened, eg in the case of MMFs, with a direct reference to providing the information required under article 27 of the MMFR.

Q31: What is your view on disclosing to investors in general the degree of investor concentration? For example, the percentage held by the top 10 shareholders of an MMF?

The IA is cautious on this proposal, noting that by necessity (due to client confidentiality) this would exclude important details to the liquidity management of the MMF, eg the types of investors, why they are using MMFs, the activities the investors, their typical subscription and redemption flows, etc. An investor concentration level might appear high, but in practice be spread across very different types of investor. We think it is unlikely to prove useful to most investors, and could cause harm (eg trigger redemptions) if wrongly interpreted by investors.

Q32: Do you have any views on the additional 'policies to absorb losses'?

We share the view in paragraph 4.76 that the policies to absorb losses are not generally appropriate and should not be consulted on. In particular, some of these policies would lead to exposure to managers' balance sheets and could result in financial stability risks.

A key principle of asset managers is that they operate as agents, which means investors are not exposed to risks arising from the asset manager's balance sheet. In turn, as managers' own balance sheets are not exposed, this limits the linkages and possibilities of financial stability risks arising from managers' balance sheet exposures. A capital buffer for MMFs would expose MMF investors to the manager's balance sheet, and in turn increase the risk of financial stability issues arising from the MMF sector.

The ability for managers to provide external support would greatly increase the risk of contagion arising from MMFs, as this might result in the manager experiencing difficulties that then spread to other parts of the financial sector, especially if the manager is part of a banking or insurance group. Permitting external support would also lead to an unlevel playing field, with managers of well capitalised groups (eg banking groups) being far better placed to provide external support than others, eg pure asset managers. The IA therefore supports the ban on external support remaining in the UK and EU MMFRs.

As stated in paragraph 4.74, MMFs are ultimately investment products, with investment risks, although the nature of the objectives and assets held make these far less volatile and overall far less likely to experience losses than other types of investment fund. As such, investors should expect to bear losses where these arise, and should only use MMFs if they are able to bear the risk of losses.

Q33: Do you have any views on underlying money market issues?

MMFs are key participants in STFMs – in some markets, they are the only active participants. We are not aware of the MMFR having any negative impact on the functioning of these markets.

There are, however, significant problems with the functioning of STFMs, which require more attention. Although these assets are highly liquid (meaning they can be bought and sold quickly), there is very little secondary market activity, and limited transparency in these markets. These impact managers of MMFs, who have to manage around these constraints, eg by building in considerable tolerance levels in their portfolio management, holding securities to maturity and timing holding periods to anticipated redemptions, eg month/quarter end.

While paragraph 4.77 correctly states that MMFs should not be considered in isolation from the features and possible vulnerabilities in the underlying STFMs, in practice there is very little discussion in the discussion paper on STFMs, this being limited to only four paragraphs. Indeed, in the discussions that followed the market turmoil experienced in March 2020, the IA is of the view that a disproportionate amount of attention has been given to the role of MMFs, which proved robust during the crisis (with no MMFs breaching their regulatory thresholds or needing to impose LMTs), and insufficient attention has been given to the functioning of STFMs.

The March 2020 crisis highlighted significant difficulties with the functioning of STFMs, particularly in the secondary markets for these assets. Our members have noted that secondary market liquidity has typically been low for many years, especially since the reforms to the banking sector following the global financial crisis in 2008. Members reported almost no secondary market activity in both bank paper and public securities during the March 2020 crisis. Typically, these securities are bought as primary issuance and held to maturity, although MMF managers can usually rely on some buyers in the secondary market being available should they need to sell assets. The lack of secondary market participation, including from well capitalised banks refusing to buy back their own paper, resulted in managers increasing their liquidity to much higher levels to ensure minimum thresholds could be maintained during this period.

Money market instruments are not inherently illiquid – indeed, these can be transacted and settled more quickly than most other asset types, with most transactions being executed and settled within the same day once the trade has been agreed. While the nature of these assets is that many will be held to maturity and thus limiting trading levels, in order to invest with confidence in primary issuance, participants need to be assured that a secondary market will be available should the need to sell these assets arise.

The IA is supportive of initiatives to improve the functioning of short-term funding markets, such as the Bank of England's UK Money Markets Code and the European STEP program, and believes that increasing the use of digital platforms will improve trading efficiency and transparency. But these initiatives and developments are unlikely to be sufficient to address these shortcomings. The IA recommends further studies are undertaken into the functioning of STFMs and how these can be improved.

Q34: Are there other threshold effects that may act to exacerbate MMF redemptions in a stress that have not been covered in this DP?

We do not consider that there are any further threshold effects related to the MMF structures themselves.

Q35: Are there any other potential rules changes to address MMF vulnerabilities that could have net benefits? If possible please provide data to support your views.

Some targeted reforms to other frameworks might reduce redemption pressures on MMFs in times of market stress, eg allowing units in MMFs to be treated as cash for the purposes of margin requirements under EMIR, allowing counterparties to receive margin in the form of transferred MMF units rather than these needing to be sold to meet margin requirements.

Q36: What are the advantages and disadvantages of MMFs as cash management type products for different types of users compared to other solutions, such as bank deposits? Are there any barriers to persons who need cash management services from using bank deposits, instead of MMFs? Do MMFs provide unique benefits to certain kinds of end users, and if so what are these? Would any of the possible reform options in the DP significantly impact MMFs' ability to provide these specific benefits?

There are several advantages for associated with MMFs as cash management tools for financial, corporate, charity and local government investors compared to deposits. Some of the main advantages are:

Better protection though ring-fencing and diversification: these investors are typically ineligible for deposit protection schemes, such as the Financial Services Compensation Scheme, and even if they were, the sums of cash they are managing would greatly exceed the protections available. Deposit accounts expose these investors to balance sheet risk of the bank holding the deposit, whereas MMFs use a funds structure whereby the assets of the fund are segregated from those of the manager and depositary. Most MMFs provide diversification of exposure to the financial paper of several institutions, all of which have been credit assessed by the MMF manager. The only MMFs providing exposure to a single issuer are those that provide exposure to government debt, which is regarded as the most secure form of finance. In theory, these investors could diversify by holding deposit accounts with different institutions, but from an operational perspective this is far more complex than dealing with a single MMF.

Simpler account opening process: These investors can make initial subscriptions to MMFs quickly, usually the same day. The account opening procedure for commercial deposits is more complex and can take longer, particularly if the bank has to perform due diligence on the investor.

No requirement for expensive advisory, brokerage and custody arrangements: while holding money market instruments directly could be an alternative possibility for some investors, in practice the requirement for either in-house expertise or to use external advisory services to manage these arrangements, as well as needing to contract their own brokerage and custody arrangements do not make this a cost effective arrangement for most investors. Subscribing and redeeming units from a MMF is relatively straightforward for corporate treasury teams and does not require them to have particular expertise, unlike transacting directly in STFMs.

Better returns than from deposits: Unlike retail investors, institutional investors such as financial institutions, corporations, charities and local governments can be offered punitive rates for holding deposits with banks, partly due to the impact on banks own capital requirements. These investors are usually offered very low rates, and it is not unusual for them to be offered no interest or even have to pay fees for depositing cash. Although MMFs primarily aim to preserve capital and liquidity, they do also seek to provide returns in line with money markets, offering these investors a return on their cash invested.

While MMFs offer these advantages to institutional investors for cash management, it could be regarded that a disadvantage compared to bank deposits is that MMF holdings are an investment. Unlike in the case of a bank deposit (ignoring counterparty risk), MMFs are not guaranteed and their investors' capital is at risk. In the case of stable NAV MMFs such as LVNAV MMFs, the stable NAV is not guaranteed and if the MMF moves outside its 20bps collar it will move to a variable NAV. The MMFR requires that this risk is appropriately disclosed to investors in MMFs, and that though these are typically used for cash management, the capital value is not guaranteed and that even though the manager will aim to manage these, there is a possibility that MMFs may subject to market fluctuations particularly in times of stress. Feedback from our members suggests that their investors are aware of and understand these risks.

Q37: Should the UK authorities consider rule changes to the information MMFs are required to disclose to investors?

The IA is a strong supporter of investor transparency and is open to discussions with the UK authorities on this subject. However, we struggle to see any reason to for any further disclosure or transparency requirements for MMFs. Transparency standards for MMFs already greatly exceed those for almost all other fund types (with the possible exception of ETFs). The majority of MMF managers already publish or report portfolio information and risk metrics on a daily basis. Our understand is that this information is considered sufficient by investors in MMFs.

As noted in our response to Q31, we are cautious on any proposals to publicly disclose the concentration levels of top 10 investors on a regular basis. The IA considers that the potential for this disclosure to lead to misunderstandings due to information that will necessarily give an incomplete picture (due to investor confidentiality) needs to be properly explored ahead of this being implemented.