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AFG RESPONSE TO CONSULTATION PAPER

Response to the FCA consultation paper on updating the regime for Money Market Funds

AFG

The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 700 management companies, with €4600 billion under management and 85,000 jobs, including 26,000 jobs in management companies.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

RESPONSE TO THE FCA CONSULTATION PAPER ON UPDATING THE REGIME FOR MONEY MARKET FUNDS

Introduction

The Association Française de la Gestion financière (AFG) is grateful for the opportunity given by the FCA to comment on this Consultation Paper dedicated to the resilience of Money Market Funds domiciled in the UK which is of the utmost importance to maintain investors' confidence.

France is one of the three main European centers for the domiciliation and management of money market funds. French MMF represent 418 bn € at end of Novembre 2023. French domiciled MMFs represents 24% of the total and more than 70% of euro denominated VNAV MMFs.

First, it is essential to make a clear distinction between the different types of MMFs following their constant of variable dealing NAV, namely between LVNAV and VNAV.

AFG would like to remind that, by derogation granted by MMFR, LVNAV MMFs offer a constant NAV to investors as long as its mark-to-market NAV deviates by less than 20 basis points. Otherwise, the fund will have to value its assets using variable pricing. And this constant NAV is calculated by rounding the NAV to the nearest cent for a NAV at EUR 1 (every EUR 0,01 move)1. As any other (UCITS or AIF) open-ended fund, VNAV MMFs have valuation as close as possible to markets' level because of the absence of collar mechanism and their strict rounding rule.

On the opposite side, VNAV MMFs' dealing NAV is market to market. We remind that MMFs aim to offer the return of short-term money markets. VNAV MMFs, as any other collective investment fund, are actively managed and are not following a systematic buy and hold strategy. More importantly they only have a marked to market pricing policy and their rounding rule is even stricter i.e. to the nearest basis point for a NAV at EUR 1 (every EUR 0,0001 move)2.

VNAV MMFs are considered as benefitting from the presumption of compliance with the criteria of the IAS 7 norm, as recalled by the November 2018 position of ANC3 (Autorité des Normes Comptables).

Most VNAV MMFs offer to investors daily subscription and redemptions with T+0 settlement.

VNAV MMFs avoid any incentivization to a first mover advantage because their NAV reflects constantly all movements in the value of its assets without the threshold/collar effect of stable NAV MMF.4 The IOSCO Recommendation 10, endorsed by the FSB and ERSB5, said "MMFs that offer a stable NAV should be subject to measures designed to reduce the specific risks associated with their stable NAV feature and to internalize the costs arising from these risks. Regulators should require, where workable, a conversion to floating/ variable NAV. Alternatively, safeguards should be introduced to reinforce stable NAV MMFs' resilience and ability to face significant

[1] EU MMFR recital 47
[2] EU MMFR recital 47
[3] https://www.anc.gouv.fr/files/live/sites/anc/files/contributed/ANC/2_Normes_internationales/NI%202018/Lettre_%20ANC_AMF-sur-les-MMF.pdf
[4] FSB Policy Proposals to Enhance Money Market Fund Resilience, Final report Oct 2021
[5] https://www.esrb.europa.eu/pub/pdf/recommendations/ESRB_2012_1_annex.en.pdf
"On 18 November 2012, the FSB published a number of consultative documents, one of which was an integrated overview of the policy recommendations regarding shadow banking. In this report, the FSB endorsed the IOSCO Recommendations as an effective framework for strengthening the resilience of MMFs to risks in a comprehensive manner. The FSB also endorsed the Recommendation that stable NAV MMFs should be converted into floating (or variable) NAV MMFs where workable. The FSB further indicated that the safeguards required to be introduced to reinforce stable NAV MMFs' resilience to runs where such conversion is not workable should be functionally equivalent in effect to the capital, liquidity, and other prudential requirements on banks that protect against runs on their deposits."

redemptions"6. For these reasons, liquidity ratios are different between VNAV and LVNAV MMFS and LVNAV have in place provisions for liquidity fees and redemption gates to ensure investor protection and prevent a 'first mover advantage'.7

To conclude, in light of all these critical differences between LVNAV vs. VNAV, MMF European MMF regulation result from an equilibrium cautiously adapted to each category which should be preserved by the upcoming FCA decisions.

AFG's detailed answers

Wider effects of this consultation

Q1: What, if anything, do you consider to be unintended consequences of this intervention?

AFG response

As specified in the Consultation Paper, many sterling-denominated MMFs are domiciled outside the UK and around 90% of total assets under management in sterling MMFs are in MMFs domiciled in the EU.

Some of the proposals in this consultation aim to create new sets of rules which could potentially lead to some overlap or frictions with the EU existing rules. The impact is clearly not limited to the UK domiciled MMFs.

Such high liquidity ratios will sterilise the available money to finance the economy. It will also drive European issuers to issue on very short terms, which will fragilise their continuous short term financing (through the rolls) in case of crisis.

The higher liquidity ratios requirement could also lead to a loss in the attractiveness of MMFs as they will have less yield and less potential of diversification compared to deposits. Another unintended consequence is that sophisticated investors could potentially decide to manage their liquidity by themselves. This loss of competitiveness could foster the internalization of the liquidity management. And this phenomenon could lead to a loss of visibility for the regulators regarding the money market oversight.

This risk was highlighted in the 2021 FSB report : "Finally, reforms that bring significant changes for MMFs could result in the emergence of new substitutes, which is more difficult to predict. Such developments could have important effects on investors and borrowers, since they could shift the risks to other parts of the financial system".

Such high liquidity ratios will uniformise the fund offer to the point that there is less diversity left for investors, but also that may trigger more uniform behaviors in the market, which is the opposite effect to the search of market stability.

[6] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf
[7] EU MMFR recital 48

RESPONSE TO THE FCA CONSULTATION PAPER ON UPDATING THE REGIME FOR MONEY MARKET FUNDS

Liquidity-related threshold effects and usability of liquidity resources

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

AFG response

Q3: Do you agree that we should revoke FG22/3, but retain its guidance on managers returning the fund to the relevant regulatory minimums as Handbook guidance in MMFS?

AFG response

Q4: Do you have any overall comments on our policy position on other options to increase the usability of MMF liquidity resources?

AFG response

Introducing higher minimum liquidity buffers

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.

AFG response

The suggestion to increase by regulation or to reshape the liquidity buffers has higher drawbacks than advantages. To say it short, the adequate liquidity ratio that ensures to meet any redemptions at any time is 100% cash when the market is frozen or when no further liquidity can be created via the selling of assets. The higher the "imposed" calibration, the higher the permanent industry-wide sterilisation of investee's monies. Retaining the possibility to individually increase these buffers on a fund-by-fund level above the "minimum regulatory" one, which is already the case and as demonstrated by fund managers during previous stress episodes, is the most efficient solution.

Moreover, it is worth highlighting the fact that defining a priori what is (by essence) a liquid asset is particularly difficult and even short term government Bills that are deemed to be liquid have experienced periods of squeeze, volatility or illiquidity during episodes like the US shutdown, the euro zone break up or any other country specific issues (ie : Greece, Italy, UK...). Before imposing any additional buffer of so called "liquid assets", we should make sure that at any given time, these assets will not become the next source of stress.

AFG would like to take a step back and remind that liquidity is not a fixed concept and that at some time even "the highest quality government assets" may face liquidity difficulties. One should not presume too much on the matter and overemphasize the expected behaviour of presumably more liquid instruments in the eye of a liquidity storm. Even if a presumed hierarchy of liquidity exists among the various asset classes, liquidity is not naturally attached to one asset class or another. The relative liquidity of assets can vary over time, affecting the cost or the time needed to liquidate the position held in the portfolio, and can sporadically be reduced or even disappear in case of a serious liquidity crisis in a given market segment. Liquidity is a dynamic and relative notion.

Regarding the liquidity ratio, the consultation paper explains that sterling MMF have consistently held close to 50% WLA in aggregate since March 2020. Consequently, proposed raise simply hardwire an existing practice followed by UK MMF managers. This figure of 50% can partially be explained by the necessity to avoid dropping below a minimum WLA level of 30% of asset. Because of the link with LMT activation to be decided by the Board and exacerbated first-mover advantage it could result, it is usually too risky for LVNAV MMF managers to effectively use this 30% liquidity buffer to meet redemption orders. As a matter of fact, it is the additional 20% WLA which is intended to be used.

Starting from this observation, the proposal of a minimum WLA level of 50% could potentially be considered as not as justified as it appears to be. It seems clear that a lower level proved to be sufficient since March 2020.

AFG response

AFG would like to put an emphasis on the fact that VNAVs and LVNAVs are MMFs that bear an essential difference regarding the dealing price, one based on market value, the other on a constant value. This difference explains structural differences, notably on the supplementary amount of immediate liquidity needed to counterbalance the constant NAV dealing. As a matter of fact, many underlying assumptions which lead to the proposals of increasing the liquidity buffers do not hold for VNAV.

Most of the time, MMFs hold most of their assets to maturity and redemptions are met from the MMF liquidity pool. Then, requiring higher liquidity ratios may make sense. However, this does not hold for VNAV MMFs because these funds sell assets regularly to meet redemptions. The Bank of England model assumption where no asset sales occur does not fit with the current mode of VNAV operation. Consequently, DLA and WLA levels should continue to be differentiated between VNAV et LVNAV MMFs, as it is the case in MMFR.

Since the assets of VNAVs are marked to market, it allows them to carry out these assets sales seamlessly with limited impact on their NAV. There is thus no need to increase the liquidity ratios for VNAVs also because the need to compensate for the discrepancy with a dealing NAV based partly on cost accounting is inexistent.

If UK legislators envisage to propose an increase of liquidity ratios so as to enhance MMF resilience, it should be recalled that a too high increase will jeopardise the usefulness of MMFs to finance the economy, will diminish the interest of investors for MMFs comparative to bank deposits, will result in paper squeeze and/or important cash amounts held in depositary's account.

AFG thus disagrees to increasing liquidity ratios for VNAVs.

Moreover, for VNAV MMFs the current size of liquidity buffers does not reflect the ability to face redemption orders because they also sell assets. Consequently, investors are less prone to monitor liquidity levels in order to redeem ahead of the prospect of a liquidity crisis. This makes VNAVs less vulnerable to first-mover advantage.

VNAV funds have countercyclical buffers as no automatic trigger is linked to the ratios and MMFR rightly gives the right to go under the level as long as no new investment is done. AFG also believes that the countercyclical feature of the existing liquidity buffers is a necessity. They are used in case of redemptions like a "Water bottle in the desert", and any potential change or addition will necessarily introduce threshold effects.

In conclusion, let aside the specific LVNAV linkage issue, the current MMFR ratios are well functioning for VNAVs and need no change. They work as any other ratio (in the asset management space) where it is expected to comply at all times and when the exceptional circumstances induce a passive breach, the asset manager makes all efforts to remedy the situation in the best interest of investors.

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

AFG response

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

AFG response

Consideration of portfolio rules and WLA composition.

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?

AFG response

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?

AFG response

Regarding the VNAV MMF derogation, there is no argument explaining the proposal to remove this flexibility. The possibility of holding MMF units within the WLA proved to have no consequence on the resilience of VNAV MMFs and their ability to meet redemption even during stressed period.

Any fund uses MMFs to manage liquidity. This is a very efficient tool to manage liquidity for funds or Treasurers. MMFs are also funds that need to manage their own liquidity, there is no logic in refusing them this tool. Market practices should continue to be recognized as part of the regulation.

AFG disagrees deleting this derogation.

Strengthening consideration of investor concentration

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

AFG response

AFG believes that the KYC for MMFs is an important tool to manage funds efficiently. Although the ultimate beneficiary and very granular data is rarely available, the management by identification of the main broad categories of investors (treasurers, corporates, funds, insurance, etc) is an appropriate way to deal with investor behavior.

Investor type categories identification allows the fund manager to detect investor concentration risks on a particular sector such as LDI funds or investors sensitive to margin calls deterioration.

Borrowing on commercial terms

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?

AFG response

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Passing on the cost of liquidity

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?

AFG response

Q13: Do you agree with our proposed rules on requirements for liquidity management procedures and tools for UK MMFs?

AFG response

MMFR has already been modified through the UCITS and AIFMD directives so as to bear one liquidity management tool.

AFG is favorable in principle with the introduction of an anti-dilution method, however AFG recalls that the operational characteristics are major.
AFG advocates strongly for a liquidity fee, which is operationally a better solution than swing pricing or ADL for money market funds. AFG thinks that, drawing lessons from the COVID-19 crisis, the legislator should look for a « systemic » utility of the tool as it should only be applied in difficult markets, not in normal ones.
The fee should take the form of a fixed percentage in relation to money market type of remuneration, ie of a few basis points. In any case, it should be avoided that the liquidity fee amounts to a « sanction ».
AFG would like to remind that from a pragmatic standpoint, all crises are dealt with in coordination. Thus, it should be acknowledged that there should be a coordinated activation and/or information with the authorities at least at the level of the currency/financial center.

Addressing risks from Stable NAV MMF

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?

Q16: Do you have any comments on our overall policy approach to stable NAV operation in the UK MMF regime?

AFG response

Developments in relation to use of MMF units

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

AFG response

Q18: What specific barriers are there, if any, to posting and accepting MMF units as collateral for non-centrally cleared derivatives?

AFG response

AFG agrees that the ability of posting MMF units as collateral could potentially reduce redemption pressure. However, this possibility should be considered very carefully. The actual impact on MMF will be difficult to assess. (*especially for non-centrally cleared transactions where the visibility is low*). Accordingly, a cautious and progressive approach should be adopted in order to control some potential interconnectedness or risk transfer.

AFG believes that MMFs have key features that could qualify them as eligible instruments. MMFs are highly regulated, well-diversified, short-term vehicles that invest in short term money markets (they are also presumed as eligible cash equivalent vehicles for their investors). They also represent the safest products in the asset management space. They are highly liquid and stable investment vehicles in normal markets. Their liquidity depends on the underlying money markets own liquidity, as they are not guaranteed products, but investment funds that pass market opportunities and risks onto their investors.

Regarding CCPs, AFG reiterates that the possible inclusion of MMFs should take into account the specificities of the European money markets and MMFs, the availability and link between different instruments that can offer CCPs an enhanced diversification of their liquidity sources. In the case of non-centrally cleared transactions, the diversification of collateral sources is also an important issue.

Q19: What do you see as the advantages and disadvantages of tokenisation in overcoming the operational barriers for use of MMF units as collateral?

AFG response

Q20: How could MMF tokenisation in general interact with the proposals to increase MMF resilience?

AFG response

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41 rue de la Bienfaisance · 75008 Paris · +33 (0)1 44 94 94 00 ▪ avenue des Arts 44 · 1000 Bruxelles ▪ www.afg.asso.fr