# FCA consultation CP23/28: Updating the regime for Money Market Funds

Insight Investment response

March 2024

BNY MELLON | INVESTMENT MANAGEMENT

# Executive summary

Insight Investment is one of the UK's largest asset managers. We manage c.£647.8bn of assets for institutional clients, of which £24.5bn accounts for money market funds.[1] Our money market funds (MMFs) are domiciled in Ireland and the vast majority are denominated in sterling and distributed to UK investors. They will therefore be subject to both EU regulation as well as any UK regulation that applies for overseas funds distributed to UK investors.

We welcome the opportunity to respond to the Financial Conduct Authority (FCA) consultation on the UK money market fund regime. We support the FCA's proposals to delink liquidity buffers from the potential imposition of fees and gates. We are also grateful for the FCA's conclusions in keeping the stable NAV fund regime as this plays an important role for investors' liquidity management.

We are however concerned with the proposals to increase minimum allocations to weekly liquid assets (WLA) from 30% to 50%. We believe this could create unintended consequences. It must be noted that the strength of any money market fund is strongly linked to the strength, liquidity, and stability of the underlying short-term markets in which it invests. We are concerned that there isn't sufficient supply in bank instruments and bank repo markets to meet the increased demand if WLAs were increased to 50%.

Indeed, during year-end and quarter-end reporting periods it is not uncommon for managers to experience difficulties in placing cash with banks or investing into bank-issued instruments. This can in some instances result in managers holding cash as custody balances temporarily at significantly lower yields; which can become negative in a low interest rate environment. We believe this increases the risk of low volatility NAV (LVNAV) funds 'breaking the buck' and converting to variable NAV (VNAV) funds. A disproportionate increase in minimum allocations to WLAs, which is unlikely to be met by supply, could therefore have the unintended effect of increasing systemic risk.

We provide responses to the questions below and broadly support the Institutional Money Market Fund Association (IMMFA) response, which provides further detail.

[1] As at 31 December 2023. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.

# Questions and answers

## Question 1: What, if anything, do you consider to be unintended consequences of this intervention?

As explained in our response to Question 5, we are concerned with the proposed increase in the minimum allocations to WLAs. We believe this could lead to increased risk-taking in the remainder of the portfolio.

We are also concerned that the new rules would create significant demand for bank-issued instruments and reverse repo with banks, which would increase concentration and credit risk to banks. This could be harmful in a stressed situation.

We are concerned that there is not sufficient supply of bank instruments and bank repo markets to make this viable. During year-end and quarter-end reporting periods it is not uncommon for managers to experience difficulties in placing cash with banks or investing into instruments that would qualify as WLAs. This can in some instances result in managers holding cash as custody balances temporarily at significantly lower yields.

In a low interest rate environment we would expect greater pressure to chase these instruments due to increased minimum allocations to WLAs, where insufficient supply could lead to MMFs having to accept negative yields. This could in turn increase the risk of LVNAV funds 'breaking the buck' and converting to VNAV funds. We therefore believe that a disproportionate increase in minimum allocations to WLAs is likely to have the unintended effect of increasing systemic risk, unless changes are made to banking rules to incentivise banks to increase the supply of these instruments even during reporting periods.

## Question 2: Do you agree with our proposal to 'delink' stable NAV MMFs' liquidity buffers? Please give your reasons.

We would strongly support de-linking regulatory liquidity thresholds from suspension and gate requirements. In March 2020, many managers were selling assets not because of redemptions but to boost liquidity buffers. We think decoupling the thresholds from suspension and gate requirements would reduce such behaviours and potentially reduce asset sales that were not linked to investor redemptions.

Further, we would encourage rating agencies' methodologies to be modified accordingly. It would be important to ensure that rating agency limits do not become a driving factor of behaviour in stressed conditions.

## Question 3: 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?

No comment.

## Question 4: Do you have any overall comments on our policy position on other options to increase the usability of MMF liquidity resources?

We support the FCA's decision to make no changes to the calculations of liquidity buffers, nor to dynamically change the buffer requirements in stressed conditions.

## Question 5: 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.

We believe the proposed minimum allocation to DLAs is more manageable, but the proposed minimum allocation to WLAs is concerning. We believe a jump in the minimum allocation from 30% to 50% in WLAs is too large when viewed in light of the outflows from MMFs experienced during March 2020 and Autumn 2022, as explained on the IMMFA response to this consultation. We believe a 40% minimum allocation to WLAs would be pragmatic yet stringent.

Although the consultation paper notes (in paragraph 3.43) that sterling MMFs have consistently held close to 50% WLAs in aggregate since March 2020, a regulatory requirement of a 50% allocation to WLAs would mean in practice that MMFs hold more, such as 55%-60%, to ensure they do not breach the minimum threshold.

We are concerned that the increased minimum allocation would create significant demand for bank-issued instruments and reverse repo with banks, which would increase concentration and credit risk to banks. This could be harmful in a stressed situation. We are concerned that there is not sufficient supply of bank instruments and bank repo markets to make this viable. During year-end and quarter-end reporting periods it is not uncommon for managers to experience difficulties in placing cash with banks or investing into instruments that would qualify as WLAs. This can result in managers holding cash as custody balances temporarily at significantly lower yields.

In a low interest rate environment we would expect greater pressure to chase these instruments due to increased minimum allocations to WLAs, and where insufficient supply could lead to MMFs having to accept negative yields. This could in turn increase the risk of LVNAV funds 'breaking the buck' and converting to VNAV funds. We therefore believe that a disproportionate increase in minimum allocations to WLAs is likely to have the unintended effect of increasing systemic risk, unless changes are made to banking rules to incentivise banks to increase the supply of these instruments even during reporting periods.

The increased minimum allocations to WLAs would likely lead to increased return-seeking behaviour in the remainder of MMF portfolios, as managers seek to ensure that overall returns are not too negatively impacted. This could lead to 'barbelled' portfolios which in a stressed situation would not support overall financial stability, because once more liquid assets are sold, the remaining assets in portfolios would likely be less liquid than they are today.

The strength of any money market fund is strongly linked to the strength, liquidity, and stability of the underlying short-term markets in which it invests. We note the reduction in liquidity in bank repo and bank instruments in recent years as banking regulations have tightened. This, combined with increased demand for liquidity and increased funding by non-banks – partly due to regulations incentivising more collateral for derivatives transactions to be posted in cash rather than in other forms – has had a knock-on effect on money market funds, particularly in stressed conditions such as March 2020 or Autumn 2022. We request regulators look at this imbalance and ensure that bank capital rules are calibrated appropriately for the overall stability of financial markets.

## Question 6: Do you agree with our assessment of the market impact? Are there other factors we should consider?

We disagree with the assessment of the market impact. As stated above, although the consultation paper notes (in paragraph 3.43) that sterling MMFs have consistently held close to 50% WLAs in aggregate since March 2020, a regulatory requirement of a 50% allocation to WLAs would mean in practice that MMFs hold more, such as 55%-60%, to ensure they do not breach the minimum threshold.

Also as stated earlier, we are concerned that the increased minimum allocation would create significant demand for bank-issued instruments and bank reverse repo transactions, which would not be met by supply. This could lead to the unintended effect of increasing systemic risk.

## Question 7: Do you agree with the resulting balance between daily and weekly liquidity requirements? How does the balance between these elements impact resilience?

We believe the proposed minimum allocation to DLAs is more manageable, but the proposed minimum allocation to WLAs is concerning, as explained above. One way to address the increased proposed minimum allocation to WLAs would be to permit MMFs to fall below the minimum threshold if the regulator identifies an extreme market event. However, we believe a lower and more realistic WLA minimum allocation (e.g., 40%) would be preferable to the proposed minimum, which would be more likely to lead to unintended consequences.

## Question 8: 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? Please give reasons for your answer. Do you have views on what public sector debt should be permitted in this derogation?

We support the proposal for VNAV funds as performance will reflect any mark-to-market volatility of these assets. We are less in favour of this rule being applied to constant NAV (CNAV) and LVNAV funds because in a stressed situation highly liquid quasi-government debt instruments can exhibit significant mark-to-market volatility.

## Question 9: 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?

We agree with this removal as holding other MMFs would increase interconnectedness risk.

## Question 10: Do you agree with our proposed rules changes to strengthen and broaden the existing MMFR KYC requirements for managers of all MMFs?

We agree with high standards of 'know your client' and support the FCA not applying hard limits or public disclosures as that could exacerbate a problem in a crisis. We question the proposal in paragraph 3.77 of the consultation paper as to how a manager can take action to change its investor base.

## Question 11: 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 do not see commercial borrowing as a practical solution. Banks are not likely to have appetite to lend at commercially attractive terms.

## Question 12: Do you have any comments on our overall policy approach to the issue of passing on the costs of liquidity to redeeming MMF investors?

We support the proposals.

## Question 13: Do you agree with our proposed rules on requirements for liquidity management procedures and tools for UK MMFs?

We support the proposals.

## Question 14: Do you agree with our proposed rules on the enhancing stress testing for stable NAV MMFs?

We are fine with the proposals to have enhanced stress testing as being proportionate.

## Question 15: Do you agree with our proposed rules on the enhancing operational resilience for stable NAV MMFs?

We believe it is pragmatic to expect mangers to be operationally ready to be able to switch LVNAV funds to VNAV funds.

## Question 16: Do you have any comments on our overall policy approach to stable NAV operation in the UK MMF regime?

We welcome the FCA's decision in allowing LVNAV funds to carry on operating as these provide an important facility for investors. We do believe that increased liquidity buffers and stress testing would significantly reduce the likelihood of LVNAV funds approaching the 'collar of 20bps.

## Question 17: In your view, what are the advantages and disadvantages of investors posting and accepting MMF units as collateral for non-centrally cleared derivatives?

We would support the ability to post MMF units as collateral for non-centrally cleared derivatives. Being able to post MMFs as collateral directly, rather than needing to sell them to release cash to post as collateral instead, could prevent some redemptions from MMFs in a collateral crisis, thereby increasing the resilience of MMFs and the system overall.

In the same manner, we also support greater recognition of MMFs as eligible for posting as initial margin for cleared contracts.

## Question 18: What specific barriers are there, if any, to posting and accepting MMF units as collateral for non-centrally cleared derivatives?

No comment.

## Question 19: What do you see as the advantages and disadvantages of tokenisation in overcoming the operational barriers for use of MMF units as collateral?

We support this proposal. As explained above, being able to effectively post MMFs as collateral directly, rather than needing to sell them to release cash to post as collateral instead, could prevent some redemptions from MMFs in a collateral crisis, thereby increasing the resilience of MMFs and the system overall.

## Question 20: How could MMF tokenisation in general interact with the proposals to increase MMF resilience?

We support this proposal. As explained above, being able to effectively post MMFs as collateral directly, rather than needing to sell them to release cash to post as collateral instead, could prevent some redemptions from MMFs in a collateral crisis, thereby increasing the resilience of MMFs and the system overall.

## Question 21: Do you have any comments on the proposed drafting in MMFS? In light of the explanations given in Appendix 1, are there are any areas where you consider we may have inadvertently changed the policy?

No comment.

## Question 22: Do you have any feedback on our proposed drafting of MMFS with regard to the definition of 'commodities'?

No comment.

## Question 23: Do you agree that the Handbook should revert to original intention of EU MMFR Article 10?

No comment.

## Question 24: Do you agree that these modifications do not make a material change to MMF rules?

No comment.

## Question 25: Do you agree that MMFs depositing cash with such public bodies should be regularised with explicit text in regulation?

We support this proposal. However, EU-domiciled MMFs are currently unable to deposit cash with UK banks due to a lack of third-country equivalence. We encourage the FCA to work closely with EU regulators to close this gap.

## Question 26: Do you agree that UK MMFs should be able to enter into reverse repurchase agreements that can be terminated by giving prior notice of no more than 5 days?

Since our sterling MMFs are domiciled in the EU but sold to UK investors, this would only be helpful if the EU MMF regulations permitted this.

## Question 27: Does the Handbook drafting setting out the requirements of UK MMFR Articles 17(7)(a)-(d) represent a material change from the UK MMFR?

No comment.

## Question 28: Do you agree that these provisions are not relevant to the UK financial sector and can be deleted without affecting the operation of MMFs in the UK?

Yes, we agree.

## Question 29: Do you agree with the overall approach to stress testing, reporting and supervisory requirements? Please set out the reasons for your answer.

No comment.

## Question 30: Do you have any comments on our cost benefit analysis?

No comment.

# Contact


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|---|---|
| Main contact | Vanaja Indra |
| Title | Head of Public Policy |
| Telephone | +44 20 4570 2090 |
| Email | vanaja.indra@insightinvestment.com |
| Address | 160 Queen Victoria Street<br>London EC4V 4LA |