Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Dear FCA,

Financial Services Consumer Panel response to FCA Consultation Paper: Updating the regime for Money Market Funds

The Financial Services Consumer Panel (the Panel) welcomes the opportunity to respond to the FCA's consultation paper on updating the regime for Money Market Funds (MMFs).

The Panel's interest in MMFs stems from the fact that these instruments can be held both directly and indirectly (for example through pension funds or in multi-asset funds/fund of funds) by retail investors. The Panel supports the aims set out in this Consultation Paper, namely that MMFs should be resilient and that liquidity issues should be managed in a way that does not disadvantage different types of investors. The Panel would also like to stress the importance of consumers having the opportunity to understand any regulatory changes that may impact them – this would need to be clearly communicated by any firm – especially in financial promotions.
The Panel's previous response[1] to the FCA/Bank of England consultation on the Resilience of Money Market Funds set out its position on consumer understanding. The Panel has also developed its thinking on disclosures and labelling, which can be found in its response[2] to the FCA's consultation on Sustainable Disclosure Requirements (SDR) and investment labels. We would encourage the FCA to consider comments made within these responses alongside this response.

As noted in Chart 3 of the section *How MMFs are used*, retail investors account for only about 10% of MMF assets, which is not surprising given that the average value of each person's portfolio is likely to be significantly lower than most corporates. Retail investors are not

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[1] https://www.fca.org.uk/panels/consumer-panel/publication/final_fscp_response_-_resilience_of_money_market_funds.pdf
[2] https://www.fca.org.uk/panels/consumer-panel/publication/final_fscp_response_fca_-_sustainability_disclosure_requirements_cp22-20.pdf

specifically mentioned in this section, however, paragraph 2.18 provides reasons why institutions use MMFs, which are the same reasons that retail investors do.

Furthermore, when the assets of pension plans are added to those of retail investors, this total is closer to 25% of UK MMF assets, which is considerable.

The Panel notes the importance of multi-national, multi-jurisdictional coordination concerning MMFs. UK regulated MMFs only represent around 10% of sterling denominated MMFs held by UK investors, which means that international cooperation is needed to ensure that equivalence can be maintained (particularly with EU regulators). The European Securities and Markets Authority (ESMA) has led work in this area, including its Final Report[3] on MMF Regulation, ESMA34-49-437 dated 14 February 2022. US authorities have also been proactive in improving resilience. However, along with some other commentators, including rating agency Fitch[4], the Panel believes that MMFs will remain vulnerable to severe outflow scenarios until market structures are reformed to facilitate smoother trading of short-term securities during market stress.

MMFs are particularly vulnerable to symmetric shocks, meaning that if several MMFs face large redemptions at the same time, they will all try/struggle to sell the same type of assets simultaneously. Whilst The Financial Stability Board is working on steps to improve how the short-term funding market functions, this underscores the necessity to ensure that retail investors understand the risks inherent in MMFs and that providers ensure that they are suitable in line with Consumer Duty compliance requirements.

Please find the Panel's responses to the questions posed in Annex 1.

Yours sincerely,

Helen Charlton
Chair, Financial Services Consumer Panel

[3] https://www.esma.europa.eu/sites/default/files/library/esma34-49-437_finalreportmmfreview.pdf
[4] https://www.fitchratings.com/research/fund-asset-managers/uk-mmf-reforms-would-reduce-rating-risks-from-redemption-restrictions-09-01-2024

Annex A – Response to consultation questions

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

The proposals may have some adverse impacts upon how MMFs are perceived and used by retail investors.

These funds can serve as a 'port in a storm' as was the case at times in 2023, as rising interest rates, muted economic activity and market volatility made MMFs relatively attractive. In March 2023, European investors poured more than €34bn into money market funds, according to data from Refinitiv[5] (May 2023), more than offsetting a combined €23bn in outflows from all other categories of fund, including shares.

October 2023 was the worst month in terms of MMF outflows in more than a year. Across active and passive strategies, investors redeemed €43.4bn in 31 days as they looked for the safety of money market products, which took in €40bn over the month[6]. This demonstrates that inflows to MMFs can be as rapid as the outflows and the issues that this CP seeks to address.

To the extent that improved access is traded off against lower rates due to reductions in duration, there is a risk that MMFs may be a relatively less attractive safe haven. This could encourage retail investors to remain exposed to market conditions for longer or direct their assets that may have flowed to MMFs to alternative instruments that may involve less regulated and more risky options.

The Panel notes that ESMA recognised the potential impact of removing Stable NAV pricing for LVNAV MMFs, with LVNAV MMFs currently constituting 46% of the market. ESMA has committed to assessing its consequences on investors and financial stability, and in particular, "whether investors may seek to rely on other products offered by banks or non-banks and the related risks be transferred elsewhere in the wider financial services market, both within the EU and globally"[7].

The Panel continues to believe in the need for products to be better designed, labelled, and described to enable consumers to better understand fully the opportunities, risks and costs involved and easily compare these across options.

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[5] https://www.fidelity.co.uk/markets-insights/investing-ideas/funds/money-market-funds-a-port-in-the-storm/

[6] https://citywire.com/selector/news/red-october-european-funds-sink-with-biggest-outflows-in-a-year/a2430930

[7] See ESMA Final Report ESMA34-49-437 dated 14 February 2022 and its first MMF Market Report published February 2023 https://www.esma.europa.eu/sites/default/files/library/ESMA50-165-2391_MMF_market_2023.pdf

Q2. Do you agree with our assessment of the type of costs (both direct and indirect) which may materialise as a result of our proposed regime? Are there other types of costs we should consider?

The Panel notes that the consultation paper states that the FCA would not change or remove currently available Stable NAV MMFs, as this could cause investors to crystallise losses if changes were made. In its response to DP 22/1, the Panel recognised that Stable NAVs are subject to significant threshold issues that will impose losses on remaining investors once the underlying value of the real NAV breaches its collar. However, in early 2020 following liquidity concerns, money moved into Stable NAVs, suggesting investors valued the ability to redeem at par, even though the ability to redeem at par only exists providing the collar has not been breached. This therefore raises two questions that will determine whether Stable NAVs add value, or should be removed:

1. Do investors in Stable NAVs, including retail investors, properly understand the implications of the collar?
2. Does the pricing of Stable NAVs properly reflect the threshold risks when compared to the pricing of other Low Volatility NAVs?

The Panel remains concerned about whether retail consumers are fully aware of the implications of 'delinking' liquidity buffers in terms of risk, access and costs.

Whilst supporting the aim of making liquidity buffers more useable, in order to avoid or reduce threshold issues, the Panel is not convinced that removing formal links between minimum liquidity levels and the imposition of fees and gates would be helpful for four reasons:

1. The proposed removal of formal links would not remove the requirement for fund managers to impose fees and gates when appropriate. Instead, the imposition of fees and gates would be done at fund managers' discretion, as part of their requirement to act in the best interests of all fund investors. Therefore, the removal of a formal link will potentially not eliminate the first mover advantage, as early movers will still be able to redeem their investment on favourable terms in situations where fees and gates subsequently need to be imposed.
2. The lack of a formal link would make it harder for consumers to understand the risks they face, by making it less clear how individual fund managers may react.
3. The lack of a formal link may increase the likelihood of fund manager decisions being challenged by investors. This may cause fund managers to delay imposing fees and gates to avoid such

challenges, to the detriment of the consumers that remain invested in the fund.

4. Uncertainty about how and why individual fund managers may react could increase market contagion, by causing early redemptions to rise for all funds, if an individual fund manager were to impose fees and gates, even if their reason for doing so was for idiosyncratic, fund specific reasons. Increased risk of contagion causing early redemptions would be detrimental to consumers, particularly retail consumers who may be at an informational disadvantage compared to investment firms.

ESMA's report[8] ESMA 34-49-437 stated that whilst some respondents to their research felt that MMFs are resilient in crisis time, since no MMFs had to use fees and gates or suspend redemptions, other respondents felt that this should not mask the structural vulnerabilities of MMFs revealed by the 2020 crisis.

Q3. Do you agree with our assessment above, and throughout this DP, that benefits, including cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, increased competition, could materialize from regulating fiat-backed stablecoins as a means of payment? Are there any other benefits which we have not identified?

The Panel has no comment on the mechanism to guide market participants.

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

Whilst the improvement in the usability of MMF liquidity resources is important, this should not be at the expense of the interests of retail consumers. The Consumer Duty and its principles of fair value and foreseeable harm must be borne in mind in the policy position and the selected options.

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 you reasoning.

The Panel accepts the need to support liquidity and to mitigate the mismatch of access and duration within MMF holdings, recognising the trade-off in the lower returns this may result in.

[8] https://www.esma.europa.eu/sites/default/files/library/ESMA50-165-2391_MMF_market_2023.pdf

Retail investors and pension plans do not generally use MMFs for collateral calls, which is described as the primary driver of liquidity issues in the MMF market.

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

The Panel agrees with the overall assessment of the market impact but reiterates that it is important to establish whether retail investors in MMFs properly understand the products that they are investing into, including the risks they may face if they need to get their money back.

This is especially important in respect of transparency as the proposals require UK MMFs to have at least one LMT to be used while the fund is still open for dealing, albeit entirely at the discretion of the MMF manager. The requirements of the Consumer Duty must be considered in this process.

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

The Panel agrees with the proposed balance.

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

The capacity of UK liquid Government debt is noted in the consultation paper and the Bank of England's Financial Policy Committee judged that significantly more shorter-maturing assets than currently required was likely to be the most effective way to increase MMF resilience and so reduce risks to financial stability.[9]

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

The Panel agrees that this derogation should be removed and has previously expressed its concerns about a domino effect or cross-

[9] FPC minutes December 6 2023

contamination of a run-on funds with negative consequences for investors.

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

The Panel welcomes the proposal and its contribution to supporting resilience and retail investor protection. As with stress testing requirements, the requirements should be in line with European regulations to enable retail investors to rely upon common governance standards.

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?

Any consequential change in the risk profile of the fund as a result of using a commercial borrowing facility should be clear and obvious to any prospective retail investor and should form part of the disclosure and labelling regime which the Panel advocates.

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?

The Panel supports the principle of reducing unfair advantages accruing to first movers, especially as retail investors may be at a relative information disadvantage to commercial professional investors. However, it is also important that the disclosure of the total potential cost of ownership must be made clear upfront, including the costs of redemption and how they are calculated.

The Panel has concerns that the tools used to deter redemptions are at the discretion of the manager not the regulator. Our response to Question 2 sets out the Panel's concerns about removing the formal links between minimum liquidity levels and the imposition of fees and gates. Fund managers will need to ensure that the buffer against unfair early redemption does not act as such a deterrent to retail investors that they are effectively locked in and suffer a poor outcome under Consumer Duty provisions as a result.

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

The Panel has expressed its concerns on delinking; a preference for prescribed versus manager-imposed liquidity management tools and the potential benefits of counter-cyclical minimum liquidity requirements (at a market rather than fund level). The Panel is particularly concerned that retail investors should be safeguarded and that the proposed rules are properly coupled with Consumer Duty requirements. The full lifecycle of a product or service should have the appropriate governance and evidence that the design, approval, marketing and ongoing management have been created with a specific target customer profile in mind. This must be accompanied by a fair value customer proposition; evidence of consumer understanding and appropriate customer support to meet the four key outcomes under Consumer Duty.

Q14. Do you agree with our proposed rules on enhancing stress testing for Stable NAV MMFs?

The Panel notes that ESMA published its Final Report on the Guidelines on stress test scenarios under the Money Market Funds Regulation (MMFR) on 19 December 2023. The Panel supports the harmonisation of UK and EU stress testing standards for Stable NAV MMFs.

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

No comment.

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

Please note the Panel's views in response[10] to DP22/1 on the benefits of introducing counter cyclical minimum liquidity requirements at a market rather than being set on a fund-by-fund basis. This would give the authorities the ability to reduce liquidity requirements in periods of market stress, freeing up liquidity to meet redemption needs when most needed.

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

The Bank of England set out the advantages and disadvantages in PS11/2[11]. Whilst there are potential advantages in terms of diversification

[10] https://www.fca.org.uk/panels/consumer-panel/publication/final_fscp_response_-_resilience_of_money_market_funds.pdf

[11] https://www.bankofengland.co.uk/prudential-regulation/publication/2022/december/margining-requirements-for-non-centrally-cleared-derivatives

lowering the risk of default; liquidity and lowering the overall cost of collateral, the BoE also noted three key disadvantages:

- Market risk: The value of MMF units can fluctuate based on market conditions, which can lead to losses.
- Regulatory risk: Changes in regulations can impact the use of MMF units as collateral for non-centrally cleared derivatives.
- Counterparty risk: There is a risk that the counterparty may default on the derivative contract, which could result in the loss of the collateral.

These disadvantages represent new risk factors for all retail investors, including those in MMFs. The Panel sees this as another reason to take a holistic approach to consumer investments regulation and Consumer Duty. Firms must be held accountable for their operational processes and procedures with a clear line of sight to the marketing, labelling and comparability of different investment options. Firms must have regard to the consumers' overall suitability for and understanding of the products and the implications of the underlying tools being employed by firms which may affect consumer outcomes.

Q18. Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.

No comment.

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

The conversion of assets into digital tokens has a number of potential indirect benefits to retail investors and to the operational efficiency of investment markets overall, not just in relation to MMFs and collateral lending. However, the Panel believes that there are several key requirements to implement tokenisation:

- A new regulatory framework is required to overcome legal and compliance risks.
- There needs to be a trusted and credible central authority in a tokenised system, such as a custodian.
- The use of tokenisation must be part of the disclosure and comprehensible information regime that the Panel is calling for concerning retail investors and meeting the Consumer Duty requirements.

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

The Panel recognises the potential benefits of tokenisation in liquidity management and therefore MMF resilience but subject to overcoming the significant challenges outlined in the response to Question 19 and below:

- A new regulatory framework is required to overcome legal and compliance risks.
- There needs to be a trusted and credible central authority in a tokenised system, such as a custodian.
- The use of tokenisation must be part of the disclosure and comprehensible information regime that the Panel is calling for concerning retail investors and meeting the Consumer Duty requirements.

Q21. Do you have any comments on the proposed drafting in MMFs? In light of the explanations given in Appendix 1, are there any areas where you consider we may have inadvertently changed the policy?

No comment.

Q22. Do you have any feedback on our proposed drafting of MMFs with regard to the definition of 'commodities'?

The Panel agree that MMFs should not have direct or indirect exposure to commodities and concurs with the proposed definition, which is in line with UK MiFID/MiFIR rules.

Q23. Do you agree that the Handbook should revert to original intention of EU MMFR Article 10?

No comment.

Q24. Do you agree that these modifications do not make material changes to MMF rules?

No comment.

Q25. Do you agree that MMFs depositing cash with such public bodies should be regularised with explicit text in regulation?

The Panel believes in and supports the principle of transparency for retail investors.

Q26. 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?

No comment.

Q27. Does the Handbook drafting set out the requirements of UK MMFR Articles 17(7)(a)-(d) represent a material change from the UK MMFR?

No comment.

Q28. 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?

No comment.

Q29. Do you agree with the overall approach to stress testing, reporting and supervisory requirements? Please set out the reasons for your answer.

As per the response to Question 14, the Panel supports alignment with a pan-EU approach and notes the ESMA stress testing proposals released on 19 December 2023 which the UK authorities should consider.

Q30. Do you have any comments on our cost benefit analysis?

Table 3 on page 66 notes that there is an impact to yield estimated at less than 10 basis points. It would be helpful to understand the interest rate scenario on which this is based and to ensure that the impact of a high interest rate scenario is captured. According to the Bank of England data, our recent experience of low rates is an anomaly.[12]

[12] Bank Rate history and data | Bank of England Database