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

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By email: AMFPolicy@fca.org.uk

Dear Sir / Madam,

Financial Services Consumer Panel response to FCA/Bank of England consultation on Resilience of Money Market Funds – DP22/1

The Financial Services Consumer Panel (the Panel) is an independent statutory body. We represent the interests of individual and small business consumers in the development of financial services policy and regulation in the UK.

We welcome the opportunity to respond to this consultation on how to improve the resilience of 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 Discussion Paper, namely that MMFs should be resilient and that liquidity issues should be managed in a way that does not disadvantage different types of investor. As many of the questions posed are technical in nature, and clearly aimed at market participants, rather than answering the questions set out in the consultation, we provide some overarching views on how investment markets should be regulated, then confine ourselves to commenting below on five key themes and finally, some other issues to consider.

While MMFs are not primarily focused on the retail investment market, they are held by retail investors, meaning that the regulation in place should be effective to deal with the needs of this type of investor. In general, the Panel considers it important that the overarching regulatory regime governing retail investments, including financial promotion rules, provides a coherent approach to setting regulation that meets consumers' needs.

Our response should be considered in the context of our vision for how the market should function, which is set out in our response to the FCA's call for input on consumer investments. The foundation of this vision ties in with the FCA's upcoming New Consumer Duty[1]. This would make the firm responsible for the appropriate distribution of investments including the marketing, labelling and comparability of different investment options, as well as consumers' overall suitability for and understanding of the products which they invest in. This would create a market where:

[1] For our comments on the FCA's proposed new Consumer Duty, please see here: https://www.fs-cp.org.uk/sites/default/files/final_fscp_response_cp21-36_a_new_consumer_duty_20220214.pdf

- the information disclosed to potential investors is designed in a way that will allow them to make effective decisions, and to compare the risks and rewards not only of different options for a given product type, but also of different products;
- it is not possible to use regulatory arbitrage to circumvent rules designed to protect consumers;
- there is a common industry-wide definition of consumer segments (such as 'high net worth', 'novice' or 'able to sustain losses'), which is used to inform product design, set purchasing channels, target marketing and ongoing engagement;
- the use of client self-certification is removed;
- information, education, guidance and advice is readily available and tailored to the consumer to ensure they are supported in taking decisions both pre-investment and on an ongoing basis. This will require the re-engineering of current thinking to better integrate these aspects together and blend them throughout the customer's investment life-cycle. Only in this way will trust be established and consumers supported through what is an inherently complex set of decisions;
- the use of guidance or advice should be the gateway to anything other than a range of default-based, simple, tax-efficient investments; and
- when harm does occur, there must be easily accessible and efficient redress and compensation solutions.

1. Increasing the minimum liquid asset requirements for MMFs

The Panel considers that increasing the share of liquid assets held by MMFs would potentially help reduce the likelihood that concerns about liquidity triggering pre-emptive withdrawals. If MMFs hold a higher proportion of liquid assets, this would reduce any potential liquidity mismatch and make it more likely that they will be able to meet any unexpected increase in redemptions. This in turn would reduce the likelihood of creating situations which lead to a first mover advantage, to the detriment of investors remaining in the fund. The Panel is therefore supportive of measures that would improve the liquidity of MMFs, where this would reduce the likelihood of liquidity problems arising. This is particularly the case as retail investors are often at an informational disadvantage compared to professional investment firms, meaning they are more likely to suffer the negative impacts when others are 'first movers' .

The Panel notes that increasing liquidity requirements will potentially reduce the returns available through MMFs. However, the Panel considers that any increase in liquidity requirements would be compatible with the primary use of MMFs, which is as a cash management tool.

The Panel notes the specific issues around the size of short-term public sector debt markets in the UK, and agrees that any changes to minimum liquid asset requirements for sterling MMFs will need to be carefully calibrated to avoid problems in this market.

2. Making liquidity buffers more useable

Regardless of the level at which liquidity buffers are set, there are still potentially threshold issues that might cause perverse market outcomes. The Panel agrees that it is important to find ways to make liquidity buffers more useable, in order to avoid or reduce threshold issues, and considers that this should be an important goal of reform.

To achieve this the Panel considers that there could be merit in introducing counter cyclical minimum liquidity requirements, whereby authorities have the ability to reduce liquidity requirements in periods of market stress. This would have the benefit of freeing up liquidity to meet redemption needs, when it was most needed within the MMF market. The Panel considers that any such measures should be decided at a market level, rather than being set on a fund by fund basis. This would make it easier for regulators to act, and would

reduce the type of stigma for individual funds that would be associated with being given a special exemption.

3. Prescribed versus manager imposed liquidity management tools

Within the current MMF market, some types of MMF funds have a requirement for managers to impose "fees and gates" under certain conditions related to minimum liquidity levels. Concerns that such measures may be about to be introduced can lead to market participants undertaking pre-emptive redemptions to ensure that they do not face barriers to withdrawals when they finally wish to redeem their investment. By increasing the overall level of redemptions, these pre-emptive redemptions can cause the barriers they were designed to avoid being imposed. This leads to a first mover advantage, where in times of market stress withdrawing funds early can help early movers avoid the costs subsequently faced by remaining investors. UK authorities are therefore considering removing the formal link between minimum liquidity levels and the imposition of fees and gates.

The Panel supports the goal of reducing any first mover advantage.

However, 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:

- 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 need to 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 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.
- 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.
- 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.
- 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.

4. Passing on the cost of liquidity to redeeming investors

The Panel supports moves to ensure that the costs of changes to liquidity as a result of redemptions are passed on to redeeming investors and considers that this should be a key tool in reducing unfair advantages accruing to first movers. However, it will be important that any chosen calculation methodology for such costs should be clear upfront, in order to allow investors to understand the potential risks and costs they face. In addition, it is likely to be helpful to ensure that the approach used is not subject to threshold effects, as this could still potentially give rise to a first mover advantage.

5. Removing Stable NAVs from Low Volatility NAV MMFs

The Panel is unsure as to whether it would be beneficial to remove Stable NAVs from qualifying as acceptable Low Volatility NAV MMFs and considers that this would be an area that would benefit from further investigation. The Panel recognises 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:

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

6. Other issues to consider

In addition to the issues raised above, the Panel would like to highlight three specific issues in relation to how the MMF market operates:

- 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 insight should be used to consider whether there are additional ways to improve both the functioning and the description/disclosure of this market, for example through strengthening disclosure requirements.
- The fact that UK regulated MMFs only represent around 10% of sterling denominated MMFs held by UK investors means that international cooperation to ensure that equivalence can be maintained (particularly with EU regulators) will be important.
- The Panel notes that it is acceptable for an MMF to hold other MMFs. The Panel considers that it would be helpful to investigate whether these cross holdings give rise to potential contagion risks in times of market stress. If MMFs facing high redemptions in one part of the MMF market are liable to trigger redemptions in the MMFs they themselves hold, this could act to increase stress in the market. If such contagion is found in practice, this might suggest that cross holdings of MMFs by other MMF managers is unhelpful and should potentially be restricted or limited in some way, or possibly prohibited.

Yours sincerely,

Helen Charlton

Chair, Financial Services Consumer Panel