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UK Proposes Updates to MMF Regime

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TO: ICI Global Members
Europe Regulatory and Policy Committee
Money Market Funds Advisory Committee SUBJECTS: International/Global
Money Market Funds RE: UK Proposes Updates to MMF Regime

On December 6, 2023, the UK HM Treasury (HMT) and Financial Conduct Authority (FCA) each published consultations on money market fund (MMF) reform to replace the retained EU law related to MMFs with a new framework, specifically designed for the UK.[1] The HMT published a policy note and near-final draft Statutory Instrument (SI) and the FCA published a consultation paper with proposed new FCA Handbook rules (FCA Consultation).[2] Comments on HMT's SI are due on January 24, 2024, and comments on the FCA Consultation are due on March 8, 2024.

As discussed more fully below, although the updated MMF regime would retain much of the retained money market fund regulation (MMFR), it would include two significant changes that are intended to increase MMF resilience, principally by ensuring MMFs have usable liquidity sufficient to endure severe but plausible redemption stresses:

1. Increase the minimum liquidity buffers for all MMF types. Specifically, the FCA proposes to raise daily liquid assets (DLA) and weekly liquid assets (WLA) levels to 15% and 50% of their assets respectively.
2. Delink liquidity thresholds. The FCA proposes to remove the requirement for a manager to consider or activate liquidity management tools (LMTs) when the MMF breaches regulatory thresholds relating to minimum liquidity levels.

The FCA chose not to propose certain other previously considered policy measures, because they would prevent MMFs from being able to support the needs of investors or there are more proportionate ways of achieving the desired outcome.[3]

HMT Draft Statutory Instrument

The published draft SI is a near-final version, and the government welcomes any technical comments on it by January 24, 2024.

The SI provides the replacement framework for the MMFR, which became retained EU law following the UK's departure from the EU. The repeal of MMFR will be commenced in a separate SI.

The majority of the legislative framework will be the same as under MMFR, but the new legislation will include several key changes:

- Unauthorised AIFs will no longer be permitted to become authorised as MMFs.
- All overseas MMFs must be from an equivalent overseas jurisdiction in order to market in the UK. Certain passporting provisions that enabled temporary marketing permissions for MMFs that had previously been passporting into the UK will be deleted.
- Under the revised overseas MMF regime, the HMT can make a determination in respect of a jurisdiction, that is determine that a jurisdiction is equivalent and permit incoming MMFs to market in the UK, provided three policy outcomes are met:
  - Protecting financial integrity or stability in the financial markets of the UK;
  - Promoting effective market competition for consumers; and
  - Facilitating the competitiveness of the UK.[4]

The SI makes no changes to the existing framework regarding:

- The definition of MMF;
- The three permitted forms an MMF may take: (Low Volatility Net Asset Value (LVNAV), Variable Net Asset Value (VNAV), or Public Debt Constant Net Asset Value (PD CNAV));
- Requirement for MMFs to be authorised or approved; and
- Liability of MMF managers.

FCA Consultation Paper on Updating the MMF Regime

The FCA's consultation reflects its view that there should be an effective market in MMFs. It states: "The proposals are intended to mitigate risks to wider financial stability and reduce the need for central bank support in the future, whilst maintaining cash management services that meet the needs of investors."[5]

Background

The FCA states that its work should be considered part of broader international efforts to address vulnerabilities and increase the resilience of MMFs, ensuring consistently high standards in the international financial system. Pointing to the FSB 2021 MMF Report, the FCA states that its consultation takes forward FSB proposals in a UK context.

The FCA Consultation reflects an understanding that the FCA's aim should be to mitigate and reduce risk associated with MMFs rather than restrict their operations. The FCA states that measures necessary to eliminate risk would prevent MMFs either being able to operate effectively or to provide the features such as same day settlement and a high degree of NAV per unit stability that are most valued by MMF investors. This would reduce the use of MMFs and move demand for cash management products and risk to other parts of the financial markets which may not necessarily have the capacity to absorb it.

Proposed Changes

The FCA states that its proposals are intended to increase MMF resilience in both business-as-usual and times of stress. This outcome can be demonstrated by funds meeting liquidity demands during periods of market stress without the need for extraordinary central bank intervention. Another measure of success will be maintenance, and possible, growth in investment in UK MMFs, demonstrating greater investor confidence in these funds.

The FCA Proposal reflect the comments on the Joint FCA-Bank Discussion Paper, which sought feedback on the FSB's potential options for to improve MMF resilience in the UK context. The FCA Consultation includes two of these proposals reduce the magnitude of liquidity transformation performed by MMFs, in order to enhance financial stability and investor protection:

- Increase the minimum liquidity buffers for all MMF types. The FCA proposes to increase the minimum liquid asset requirement for all MMFs, raising DLA levels to 15% and WLA levels to 50% of their assets.[6] Currently, the requirements vary between different types of MMFs (DLA levels range from 7.5% to 10% and WLA levels range from 15% to 30%). The FCA indicates that it arrived at the proposed DLA and WLA levels based on Bank of England modelling, which is provided in Annex 4 to the consultation. The FCA also proposes changes to WLA derogations to deliver a better balance between MMF resilience and flexibility for MMFs to build up their WLA. The FCA proposes to extend the existing stable NAV WLA derogation (for certain highly liquid government debt as WLA, up to 17.5% of total assets) to VNAV MMFs and to delete the current VNAV WLA derogation of holding other MMF units and certain money market instruments as part of WLA.
- Delink liquidity thresholds. The FCA proposes to remove the regulatory link between liquidity levels in MMFs that can offer subscriptions and redemptions at a constant Net Asset Value (NAV) (so-called 'stable NAV MMFs') and the need for the manager to consider or impose tools such as liquidity fees or redemption gates.[7]

In addition, the FCA proposes a few revisions to the enhance the effectiveness of the existing MMFR:

- 'Know your customer' (KYC) requirements. To address concerns that MMFs with a highly-concentrated investor base may be more vulnerable in times of stress if one or more investors seek to redeem at the same time, the FCA proposes to strengthen and broaden existing KYC requirements by requiring consideration of additional factors and sets out that a manager must take appropriate action to strengthen a MMF's robustness in light of broader investor concentration risks.
- Stress testing for stable NAV MMFs. The FCA proposes new rules that set out that stable NAV managers also need to consider their stress test scenarios factors specifically relevant to their stable NAV operation as applicable.
- Operational resilience for stable NAV MMFs. The FCA proposes to require managers of stable NAV MMFs to have in place effective arrangements, processes and systems which would allow the manager to switch to issuing and redeeming units at the floating NAV per unit. The FCA also proposes to require the stable NAV MMF manager to have in place a communication plan and strategy and an LVNAV manager to inform its board, the FCA and the depositary when the constant NAV and floating NAV per unit differed by more than 15 bps (i.e., as the collar is approached).

The FCA proposes two new rules to strengthen fund managers' ability to manage severe redemption stresses and pass on some cost of liquidity:

- requiring UK MMFs to have at least one LMT to be used while the fund is still open for dealing, at the discretion of the MMF manager; and
- ensuring managers of all UK MMFs have the ability to suspend the fund if needed by extending powers already available in relation to MMFs that are authorized under FSMA to UK MMFs that have been authorized under article 5 of the MMFR but are not authorized under FSMA.

Options Not Proposed by the FCA

Based on feedback to the Joint Bank-FCA Discussion Paper, the FCA determined to not propose several other policy options to reduce liquidity mismatch and pass on the true cost of liquidity, including:

- Changing or removing the stable NAV operation for the current stable NAV MMFs, so such funds would no longer be permitted to deal at a constant NAV;
- Adding regulatory authority to dynamically change liquidity requirements during stress events;
- Revising rules associated with liquidity buffer calculation;
- Adding a capital buffer for MMFs through a "minimum balance at risk" in which a fraction of each investor's units would be held back subordinated to other units in order to absorb losses;
- Imposing new minimum public debt requirements or maximum private sector debt limits for UK MMFs' portfolios as a whole;
- Forcing MMFs to sell a vertical slice of portfolio assets as part of normal redemption pricing procedures day-to day;
- Revising MMFR valuation rules to improve the synthetic estimate of the sale value of a vertical slice of the portfolio assets;
- Enforcing obligatory use of LMTs, such as macro-prudential swing pricing, in accordance with parameters set by authorities;
- Regulatory authority to approve the activation of fees and gates;
- Adjusting redemption terms of MMF units or other liability-side tools to reduce liquidity transformation; and
- Introducing redemption-in-kind, whereby funds could distribute underlying assets on a pro-rata basis to investors, rather than paying cash to meet redemptions.

The FCA determined that each of these policies would have significant negative effects; many of these options would interfering with MMF utility, rendering them not viable. Critically, the FCA determined to not propose any changes that would ensure that the "true" cost of liquidity is always passed on to investors, because the options are not viable or practicable. The FCA instead proposes to rely on the changes aimed at enhancing MMF resilience, so that MMFs will avoid situations that would require passing on fully the true cost of liquidity.

Short-Term Funding Markets

The FCA notes that there is potential interconnection between MMFs and short-term funding markets (STFMs). While the FCA is not moving forward with any proposals to increase the liquidity of STFMs at this time, it does affirm its commitment to improving the functioning of STFMs and is co-leading an initiative by the FSB and International Organization of Securities Commissions (IOSCO) to assess the state of STMS, exploring transparency, standardisation, and STFM microstructures.

Next Steps

Comments on HMT's SI are due on January 24, 2024, and comments on the FCA Consultation are due on March 8, 2024.

These proposals represent another stage of the UK's efforts to tailor its financial legislation following exit from the EU. As the UK moves forward to revise the retained MMFR, the UK's approach will diverge in significant ways from the EU's existing approach. The extent of the divergence, however, is not yet clear. The EU has been considering potential proposals to reform its MMFR.[8] Regulators in some EU member states, such as Luxembourg and Ireland, are also considering revisions to their national supervisory regimes that may align with at least a portion of the UK's reforms.[9]

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Notes

[1] The consultations are part of the Government's delivery of the Smarter Regulatory Framework (SRF) for financial services, replacing retained European Union (EU) law (REUL) with an approach to regulation tailored to the UK.

[2] HMT's Draft SI and Policy Note are available at https://www.gov.uk/government/publications/money-market-funds-draft-si-and-policy-note. The FCA Consultation Paper is available at https://www.fca.org.uk/publication/consultation/cp23-28.pdf.

[3] The FCA Consultation was prepared in close cooperation with the Bank of England and HM Treasury as part of the UK's response to policy options published by the FSB in its October 2021 Final Report on Policy Proposals to Enhance Money Market Fund Resilience (FSB 2021 MMF Report). The FCA Consultation follows on from the work done in the Joint FCA-Bank May 2022 Discussion Paper DP22/1 on the Resilience of Money Market Funds (Joint FCA-Bank Discussion Paper) in which they gathered feedback on the FSB policy options. Feedback to DP22/1 supports the FCA's analysis that its aim should be to mitigate and reduce risk associated with MMFs rather than restrict their operations.

[4] The FCA notes that many sterling denominated MMFs are domiciled outside the UK - around 90% of total assets under management in sterling MMFs are in MMFs domiciled in the EU. The HMT's SI sets out the Government's Overseas MMF Regime which will enable approved MMFs to market into the UK provided they apply to the FCA for recognition under the Financial Services Markets Act (FSMA) or notify the FCA under the UK's National Private Placement Regime.

[5] FCA Consultation at 3.

[6] The US Securities and Exchange Commission (US SEC) recently increased the minimum liquidity requirements for money market funds to at least 25% of a fund's total assets in DLA and at least 50% a fund's total assets in WLA. See SEC Press Release (July 12, 2023) and related materials.

[7] Under UK MMFR, a stable NAV MMF is required to consider whether to impose liquidity fees, gates that limit redemptions, temporary total suspension of the fund or to take no action other than correcting the portfolio imbalance when its proportion of WLA drops below a threshold of 30% of total assets and net daily redemptions on a single working day exceed 10% of total assets. When a stable NAV MMF's WLA drops below 10% of total assets, it must impose liquidity fees and or a fund suspension. The FCA proposes to eliminate this provision, set forth Article 34, which would be a significant departure from the EU MMFR.

The US SEC also recently removed the regulatory tie that permits MMFs to impose liquidity fees if their weekly liquid assets fall below a certain threshold. See SEC Press Release (July 12, 2023) and related materials.

[8] EC, Report from the Commission to the European Parliament and the Council on the adequacy of Regulation (EU) 2017/1131 of the European Parliament and of the Council on money market funds from a prudential and economic point of view (July 20, 2023); ESMA, Opinion on the review of the Money Market Fund Regulation (Feb. 14, 2022); ESRB, Recommendation of the European Systemic Risk Board on reform of money market funds (Dec 2, 2021).

[9] CSSF, Consultation on macroprudential measures for GBP Liability Driving investment funds (Nov. 23, 2023); CBI, Macroprudential measures for GBP Liability Driven Instrument funds (Nov. 23 2023).
