CCLA

GOOD INVESTMENT

Senator House, 85 Queen Victoria Street, London, UK EC4V 4ET

CCLA Investment Management welcomes the opportunity to comment on the Financial Stability Board's policy proposals which have been made with a view to enhancing money market fund resilience.

Overall

1.What are the key vulnerabilities that MMF reforms should address? What characteristics and functions of the MMFs in your jurisdiction should be the focal point for reforms?

CCLA supports a regulatory environment that promotes increased transparency, appropriate liquidity, greater consistency and sound fund governance principles which will result in increased safety for the money market fund industry.

The economic paralysis in March 2020 was due to an unexpected external shock from a once in a century pandemic, rather than a major credit event as occurred in 2008/09 and other previous financial crises. The seizure that transpired from an immediate global lockdown caused government interventions at every level of the economy, the financial system and society itself. As the difficulties faced were from an external shock, we believe that caution should be taken by the FSB and the other global authorities. No European MMFs, that we aware of, broke the LVNAV NAV pricing collar, duration or liquidity rules, and none had to be gated. Yes, there was stress in the system, but this is totally understandable in such a once in a lifetime event.

We believe that there is a strong case to assess the impact of reforms on individual markets rather than a broad brush approach across all jurisdictions. We do accept that some consideration will need to be given to ensure MMF access cannot be arbitraged across different markets. Our suggested reforms to sterling money markets are below.

We believe there is a strong need to ensure that regulatory liquidity thresholds and fund suspensions/ fund gates are decoupled. While we did not experience unexpected outflows from our funds during the March 2020 stress, it is apparent that this is a potential risk and, as European Money Market Fund Regulation (MMFR) states that maturity breakdowns must be published at least weekly, investors could be closely tracking fund liquidity against regulatory minimums. Should these clearly defined minimums ("Bright Lines") appear likely to be crossed, it may cause investors to pre-emptively redeem to avoid the consequences of a fund crossing those thresholds ("Cliff Effects"). This would serve to increase first mover advantage, the consequences of which could actually result in the possible implementation of fund suspensions/fund gates. We see these thresholds as a risk which could result in a run on a MMF, and understand this behaviour was observed in some markets during March 2020.

It is noteworthy, that these Bright Lines are calculable from the publications prescribed under MMFR and relate to the 30% minimum Weekly Liquid Assets (WLA), rather than a situation where a fund's WLA has been depleted and it is unable to meet redemption requests. We believe that the 30% WLA should be available to funds during times of market stress in the form of a countercyclical buffer. Determination of when it is appropriate to use this countercyclical buffer, and how much, should be made by the relevant fund board, who would advise its investors and then make the appropriate Competent Authority aware of its decision. This approach would provide additional liquidity in times of stress, remedy investor concerns surrounding access to investments and serve to prevent the prospect of a breach of minimum WLA requirements contributing to a run on a fund.

Throughout your Consultation Report, the point is made that investors value MMF's "cash-like" features, and we wholeheartedly agree with that point, especially considering the nature of our investor base which is predominantly comprised of church, charity and local authority clients. The Report makes the point that the mismatch between cash and money market assets is a form of liquidity transformation. Rather than restricting fund investments, regulation on investor communication (as currently already required by MMFR) should be put in place globally to ensure clients make informed decisions, fully aware that in times of stress, the fund may not operate in a "cash-like" way.

2. What Policy Options would be most effective in enhancing the resilience of MMFs, both within individual jurisdictions and globally, and in minimising the need for extraordinary official sector interventions in the future?

We believe recent European MMF reforms have been beneficial, helping to enhance the robust nature of MMF's. The Policy Options which we believe would be most effective in further enhancing the resilience of MMF's are:

- **Reduce threshold effects – removal of ties between regulatory thresholds and imposition of fees and gates** – for the reasons outlined in our answer to Question 1, we believe this will reduce the risk of large redemptions. Additionally, it will make fund managers more willing to use their WLA buffers to meet redemptions in times of stress, thus reducing the need to sell fewer liquid assets. We think it's important that MMF's should be obliged to continue to hold 30% of WLA, but these should be as countercyclical buffers which should be made available in times of stress as set out under the Policy Option.

  We expect the Alternative Option which requires regulatory approval to activate gates would add a layer of confusion and possibly delay to the process. We also think it would fail to address the risks of investors pre-emptively withdrawing in fear of the implementation of gates/fees.

We have concerns with the Policy Options below for the following reasons:

- **Impose on redeeming investors the cost of their redemptions – swing pricing** – We believe that this option would make it operationally impossible to provide same day liquidity to investors. This is one of the features that our clients highly value. MMF's are not long term investments, nor are investors looking for strong performance, as indicated in the Representative Option. Investors often make investments over a one day time horizon, and it would be unfair for investors to be penalised by swing pricing should they wish to withdraw shortly after investing. The assessment makes the point that swing pricing benefits investors who care primarily about a fund's safety and yield. Yield is a tertiary concern for investors and is subordinate to liquidity, an issue that is not helped by swing pricing and its impacts on same day settlement.
- **Absorb losses – minimum balance at risk** – The Representative Option needs to be clearer, will the minimum balance at risk (MBR) be a permanent feature or only employed in times of stress? How long before an investor can access the MBR? We share the concerns set out in the Representative Option that "The MBR's novelty may result in investor confusion or unease, particularly when it is first introduced, which may reduce demand for MMFs, at least for a time, and cause investors to move to other products." The accounting treatment of MBR's will also need to be addressed. We see this as being too operationally complex for it to be implemented.
- **Absorb losses – capital buffer** – The presence of a capital buffer does not solve the liquidity transformation issue which it is intended to resolve. It is unlikely to be of a sufficient scale to cover large runs of redemptions. MMF's are low margin products, even more so in todays' ultra-low rate environment. Should asset managers have to finance a buffer, it will likely lead to many fund closures, and the concentration of the MMF's sector into a small number of large funds which could result in additional risks to money markets and possibly the wider financial system.
- **Reduce threshold effects – removal of stable NAV** – Our charity, local authority and church clients value the price stability that CNAV and LVNAV funds provide, whilst being fully informed that in times of stress, the price may change. Many would not have the systems and processes to operate with an exposure to a MMF with variable prices for their cash and would likely withdraw to concentrated bank deposits and current accounts.

- **Reduce liquidity transformation - limits on eligible assets** - Our experiences were that the high quality Certificates of Deposit (CD) market remained functional throughout the March 2020 stress and limits on CD exposures are not required. The result on capping exposures to these instruments would make it harder for funds to continue to pay a positive return to investors. Completely restricting MMF's to holdings of government securities would exacerbate this. While we see some benefits in the other option suggested where liquidity buffers are structured based on the characteristics of the investment base, this may be very difficult to adopt practically and risks putting some funds at a competitive disadvantage.

3. How can the use of MMFs by investors for cash management purposes be reconciled with liquidity strains in underlying markets during times of stress?

The existing EU LVNAV rules are sufficient for this purpose. MMFR Article 36 states that:
"Any document of a MMF used for marketing purposes shall clearly include all of the following statements:
(a) that the MMF is not a guaranteed investment;
(b) that an investment in MMFs is different from an investment in deposits, with particular reference to the risk that the principal invested in an MMF is capable of fluctuation;
(c) that the MMF does not rely on external support for guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share;
(d) that the risk of loss of the principal is to be borne by the investor."
Additionally, "No communication by the MMF or by the manager of an MMF to investors or potential investors shall in any way suggest that an investment in the units or shares of the MMF is guaranteed. Investors in an MMF shall be clearly informed of the method or methods used by the MMF to value the assets of the MMF and calculate the NAV. Public debt CNAV MMFs and LVNAV MMFs shall explain clearly to investors and potential investors any use of the amortised cost method or of rounding or both."

This is a clear and appropriate rule on the disclosures which must be made to allow investors to make informed decisions surrounding the investment of their cash.

Forms, functions and roles of MMFs

4. Does the report accurately describe the ways in which MMFs are structured, their functions for investors and borrowers, and their role in short-term funding markets across jurisdictions? Are there other aspects that the report has not considered?

We believe the report is accurate in this respect. The report does state that in Europe, retail investors hold insignificant portions of MMF's, this is correct, but the interests of retail investors, such as UK charities and UK not-for-profit organisations, within MMF's should be considered as well.

5. Does the report accurately describe potential MMF substitutes from the perspective of both investors and borrowers? To what extent do these substitutes differ for public debt and non-public debt MMFs? Are there other issues to consider?

No. The assumption that bank deposits are an appropriate substitute is incorrect:
- In order to get the minimum level of diversification as a MMF, investors must open and maintain relationships with at least ten banks (in practice MMFs have exposures to far more than ten issuers). Taking the UK as an example, there are not ten domestic high quality deposit taking banks, so investors would either need to look further down the credit quality spectrum or look at putting a relationship in place with overseas banks, which a charity or local authority investor may not be sufficiently resourced to undertake. Many of these banks are not willing to open accounts for these type of clients as their individual balances are so low. The result of this would be higher concentration and/or credit risk.
- An investor may not have sufficient scale to create a liquidity profile of regularly maturing assets within their portfolio – this may therefore mean they are unable to access liquidity when required.

- As well as putting in place relationships with individual banks, investors would potentially need to set up custody and settlement facilities, all of this will result in further costs to investors who will not benefit from the economies of scale created by MMF's.
- The report simply assumes that banks will be willing to take deposits from both large institutional investors and smaller retail investors. Banks are extremely well funded at present, so much so that in the US banks are currently directing depositors to MMF's. Discussions with our UK investor base have multiple instances of banks closing accounts and relationships because of their impact on regulatory ratios and profitability, particularly if short-term interest rates are negative. Other anecdotal evidence from our clients have indicated that banks are simply not willing to open relationships.

We fail to see how short dated fixed interest funds can be a viable alternative to MMF's. Both options exist at present and MMF investors prefer the security and relative price stability of MMF's. Fixed interest funds also expose investors to further risks.

When assessing the substitute options available, we urge policymakers to consider the utility that smaller institutions gain from MMF's. A professional manager making informed judgements on credit quality at relatively low cost to investors, the benefits of scale and the access that brings to both domestic and overseas issuers allowing for diversification and, in all but unprecedented circumstances, the access to liquidity on demand.

Vulnerabilities in MMFs

6. Does the report appropriately describe the most important MMF vulnerabilities, based on experiences in 2008 and 2020? Are there other vulnerabilities to note in your jurisdiction?

We agree with the Consultation Report's view that trades in the secondary CD market are less common and that investors sought to preserve liquidity by not refinancing maturing investments. During the March 2020 disfunction, we did witness a sharp rise in yields on offer from the secondary market, but there continued to be a two way secondary market throughout the stress for well rated financial institutions.

The report includes a chart setting out "the march 2020 market turmoil." This chart is misleading. MMF's often have to accommodate outflows at quarter ends and more especially in February and March as investors pay bills and settle margin calls amongst other draws on cash ahead of the financial year end. While redemptions were undoubtedly more prevalent in March 2020 than usual, this chart should show history across a number of years rather than five months.

The report states that "redemptions from MMFs did not abate until central banks and governments in several jurisdictions intervened in a decisive and substantial way." Going further, it states that "absent to the extraordinary official sector interventions, it is likely that stress in these markets would have worsened significantly." We would like to see the evidence behind this claim. Our observations within the sterling money markets were that the stress was receding, even before central banks intervened. Whilst we recognise that central bank actions helped to stabilise markets, particularly in the US, European MMFs did not benefit directly from central bank facilities, their recovery appeared organic and the result of market stabilisation. As such, it is not reasonable to rely on the conclusion that MMFs would have failed in the absence of such support.

Policy proposals to enhance MMF resilience

8. Does the assessment framework cover all relevant aspects of the impact of MMF policy reforms on fund investors, managers/sponsors, and underlying markets? Are there other aspects to consider?

Fund Investors

It is our view, that the Assessment Framework fails to consider the impact of these reforms on funds (such as UK Common Deposit Funds (CDF's)) which are classified as Alternative Investment Fund's

(AIF) rather than MMF's but still have to comply with MMFR. Similarly, there is little consideration given to the smaller, less resourced investors such as those from the charity sector. The Assessment Framework simply assumes they could move into either bank deposits, government debt funds or short dated fixed interest funds. Complying with the Assessment Framework would have considerable adverse consequences for charity depositors. It is difficult to see how UK CDFs could comply with the proposed regulations in their current form, as they are not unitised funds. This would probably require these charities to withdraw their deposits from the Common Deposit Funds and the redeployment of their money in a bank. As set out above, they would have to expend significant resources putting in place relationships with numerous banks, recruiting an appropriately qualified treasury management function amongst other costs and would miss out on the benefits of scale. It should be noted that nearly all these charities are very small and do not have the resources to operate sophisticated functions. In addition, the yield they would earn from bank deposits would most likely be significantly lower than that paid by the MMF or require the investor to take a higher level of risk.

Swing pricing, the removal of stable NAV's and the implementation of a MBR all negatively impact the ability of MMF's to provide investors with same day liquidity. That facility is of great value to a lot of investors and ensures that the wider financial ecosystem can function efficiently. The FSB must look into the consequences of the loss of same day liquidity under many of the Representative Options.

<u>Managers</u>
It is our view that policymakers must give due consideration to the fact MMF's are a critical cog in the short-term funding ecosystem, but also appreciate these are low margin products, especially in today's ultra-low interest rate environment. The expectations that managers could either contribute to a "liquidity exchange bank" or seed a capital buffer needs more consideration. The likely result would be further consolidation in the sector, as smaller managers drop out and the creation of a few mega funds and the associated concentration risks that would bring.

9. Are the representative Policy Options appropriate and sufficient to address MMF vulnerabilities? Which of these options (if any) have broad applicability across jurisdictions? Which of these options are most appropriate for public debt and non-public debt MMFs? Are there other Policy Options that should be included as representative options (in addition to or instead of the current ones)?

We view the removal of ties between regulatory thresholds and the implementation of fees and gates as the only appropriate reform suggested. The use of the WLA buffers to act as some form of countercyclical buffer would indeed allow MMF's to access 30% of their resources in times of stress. We also agree with the proposal that some MMF's could benefit from setting a required liquidity buffer based on their own characteristics, such as its investor base. Most prudent managers should already be taking this approach.

We agree with the point made within the Consultation Report that trades in the secondary CD market are less common but dispute the finding that there is typically "little secondary market trading even under normal market conditions," this is not the case in sterling money markets. During the March 2020 disfunction, we did witness a sharp rise in yields on offer from the secondary market, but there continued to be a two way secondary market throughout the stress, especially for high quality sterling CD's. We did witness poor secondary market liquidity for CD's issued by lower quality issuers and more especially in the case of CD's with a floating coupon and Commercial Paper (CP). We would encourage policy makers to look into restricting or capping exposures to these more illiquid asset types, however we believe the high quality CD market is fit for purpose as it remained functional throughout the stress, and no further restrictions are required here.

10. Does the summary assessment of each representative option adequately highlight the main resilience benefits, impact on MMFs and the overall financial system, and operational considerations? Are there any other (e.g., jurisdiction-specific) factors that could determine the effectiveness of these options?

As previously mentioned, investor demand for same day liquidity and diversification could render these proposals academic.

12. Are measures to enhance risk identification and monitoring by authorities and market participants appropriate complements to MMF policies? Which of these measures are likely to be most effective and why? Are there other measures to consider?

Stress Testing
We view the current level of stress testing required under MMFR and stipulated by ESMA as appropriate for risk identification purposes. One further enhancement could be to stress the funds based on coordinated withdrawals of similar investor groups and sub-groups. We see little benefit of further increasing the frequency of stress test reporting.

Transparency
- MMFR stipulates a wide range of key metrics to be published on a regular basis to investors. We view this as sufficient with no further need to add additional requirements into legislation, recognising that investors can always request further data as required.
- We are currently obliged to share key data to the UK Financial Conduct Authority (FCA) on a quarterly basis under MMFR. Furthermore, on the request of the FCA, we have been providing enhanced data on a daily basis to them. We view this as sufficient with no further need to add additional requirements into legislation.

Considerations in selecting policies

15. To what extent should authorities seek to align MMF reforms across jurisdictions? Is there a minimum set of policies or level of MMF resilience that should be considered at the international level to avoid fragmentation and regulatory arbitrage?

We believe that there is a strong case to assess the impact of reforms on individual markets rather than a broad brush approach across all jurisdictions. For example, most sterling funds are not UK domiciled in their domestic currency market, whereas euro funds are. We do accept that some consideration will need to be given to ensuring that MMF access cannot be arbitraged across different markets. Our view is that, depending on their jurisdiction, investors value differing features of MMF's. For example, in the UK, investors clearly value the price stability of a CNAV and LVNAV, much more so than in France where VNAV's are far more embedded in the financial system and accepted by investors. We believe that the regulation should allow managers to appropriately serve their target market and meet the needs of participants within the confines of regulation. Imposing a one size fits all approach will simply allow one jurisdiction to benefit while another suffers.

We would recommend MMF's are required to hold the same percentage of short dated liquidity. In Europe MMF's withstood the outflow pressures well without requiring sponsor support and so our view is that 10% daily liquid assets and 30% weekly liquid assets continues to be appropriate.

CCLA Investment Management
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