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INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

Mr Andrew Hauser, Executive Director for Markets and Ms Victoria Cleland,
Executive Director for Banking, Payments and Innovation,
Bank of England,
Threadneedle Street,
London
EC2R 8AH

30th January 2020
Re: Call for evidence on 'Access to Bank of England Payments infrastructure and balance sheet for payments firms'

Dear Mr Hauser and Ms Cleland,

Thank you for inviting IMMFA to answer your call for evidence on 'Access to Bank of England Payments infrastructure and balance sheet for payments firms'. We are delighted to respond and attach a summary of our thoughts on how changes might benefit our members whilst also meeting the Bank's objectives. We have included a summary piece which first explains IMMFA's role and the relevance of the regulated money market fund industry to the question of access, and then responded with specific answers in your suggested format. We have focused on access to the Bank's overnight deposit facilities, rather than the RTGS payments infrastructure, as this has the most significant implications for regulated money market funds.

Introduction to IMMFA

The Institutional Money Market Funds Association (IMMFA) is the trade association which represents the European money market fund (MMF) industry. IMMFA's mission is to promote and support the development and integrity of the MMF industry by engaging with and informing policy makers and, amongst other things, providing a primary point of contact. We are delighted to respond to this call for evidence on behalf of our members.

MMFs play an important role in the real economy by allowing investors to manage their cash efficiently. IMMFA funds currently hold over £200bn in short term assets[1] and their activity can have a significant impact on the sterling money markets. MMFs and other funds account for an estimated 70% of deposits making up the SONIA benchmark and therefore both influence and are impacted by any changes to the current framework. Although MMFs are not 'payment firms', we believe that the issues prompting this call for evidence are highly pertinent to our members. Furthermore, we believe that broadening access to the Bank's infrastructure to include MMFs would fit with the Bank's mission to 'enable competition, while still ensuring monetary and financial stability'.[2]

[1] Source, IMMFA data.
[2] A call for evidence Access to Bank of England payments infrastructure and balance sheet for payments firms, Nov. 2019, Foreword.

Executive Summary

- Post crisis bank regulation has resulted in a decline in the appetite for short term wholesale deposits.
- Regulated MMFs offer a scalable alternative to bank deposits. They continue to attract cash and account for a substantial share of the deposit and consequently the SONIA market.
- Whilst banks are disincentivized to hold overnight or very short cash, regulated money market funds are required to do so both by their regulations and their investment parameters.
- This mismatch can be particularly acute on reporting dates. At such times it can be very difficult for regulated MMFs to find adequate deposit capacity in the market. This can have adverse consequences for the efficient operation of the funds and can also risk temporary distortions in SONIA.
- Allowing regulated MMFs to deposit directly with the Bank would alleviate the above demand constraints and 'support financial stability' in line with the Bank's objectives.
- Access would give the MMF industry the confidence to maintain their daily and weekly liquidity buffers at the desired levels, thereby limiting any broader impact on market liquidity.

Impact of banking regulation on deposit demand

One consequence of post-crisis bank regulation has been a decline in bank appetite for customer deposits. **Banks now have significantly enhanced liquidity buffers as well as much more capital. Cumulatively, UK banks now hold 65 % more regulatory liquidity than they did in 2009.** Liquidity Coverage Ratios (LCR) introduced as part of Basel III require banks to hold high quality liquidity assets (HQLA) that can be converted into cash to meet 30 days' liquidity needs.

Whilst LCR has improved bank resilience, the balance sheet effect has been to limit bank appetite for deposits under 30 days. Deposits less than 30 days have no balance sheet value, as they 'run-off'. Since cash investors need flexibility and bank borrowers need term money, 'transactions are overwhelmingly completed overnight', as noted in the Bank's Quarterly Bulletin Q1 2018. [3] Banks are strongly incentivised to seek longer term, more stable funding sources. The capacity for overnight bank deposits can therefore be seriously constrained on reporting dates and and/or at times of stress.

[3] BOE Quarterly Bulletin 2018 Q1 Sterling money markets: beneath the surface, Overview

Mismatch: MMFs required to hold cash, banks disincentivised to do so.

To recap, whilst banks have little or no economic incentive to accept very short deposits, and indeed may seek to avoid them, regulated MMFs are required to hold high levels of liquidity. This diametrical opposition between two major parties in the deposit market can lead to operational challenges for the MMFs and to temporary interest rate distortions, including a potential impact on SONIA.

As bank appetite for wholesale deposits has declined, some deposit activity has migrated to non-traditional intermediaries including MMFs which offer cash-rich investors a scalable alternative to bank deposits. As part of their conservative risk structure, MMFs are required to maintain a certain level of cash or cash equivalent holdings to ensure a high degree of liquidity. Depending on the type of regulated fund, this translates to a minimum of 7.5 % to 10% in 'daily maturing assets.' assets' including cash deposits, reverse repo and other securities which mature, or can be recalled or terminated within one working day. Similarly, it translates into holdings of between 15 % to 30 % in 'weekly maturing assets' including cash deposits, reverse repo and other securities which mature, or can be recalled or terminated within five working days. In practice, most funds typically run much higher balances in order to ensure a comfortable buffer while also accommodating daily client subscription or redemption flows. MMFs therefore provide a valuable home for short dated cash.

Investors in the funds include UK and multinational corporates, financial institutions, local authorities and pension funds, amongst others. MMFs, whilst aggregating and investing cash in longer term paper such as T bills, ECDs or ECP, do, in turn, need to place significant amounts of overnight deposits.[4] Currently the only option is to do so with a bank counterparty. The Bank's 2018 analysis of SONIA showed that 71 % of SONIA depositors were funds, of which 28.2 % were money market funds. [5]

Problems can be acute on reporting dates

Demand constraints (i.e. lack of bank appetite to receive deposits) can be particularly acute in the lead up to and on reporting dates, such as quarter ends and year ends. These periods of reduced bank appetite result in the funds having to negotiate access to commercial bank balance sheets by maintaining certain business flows during 'normal' periods. Such negotiations are informal and non-binding, *meaning that funds can still be exposed to last minute changes in bank willingness to take cash*. This element of unpredictability can be detrimental to efforts to manage a fund within the required liquidity parameters. Typically deposit demand will drop by around 20% but some bank counterparties will withdraw completely. This can also lead to distortions in interest rates.

[4] I.e. Treasury bills, Euro Certificates of Deposit and Euro Commercial Paper.

[5] BOE Quarterly Bulletin 2018 Q1 Sterling money markets: beneath the surface, p.9.

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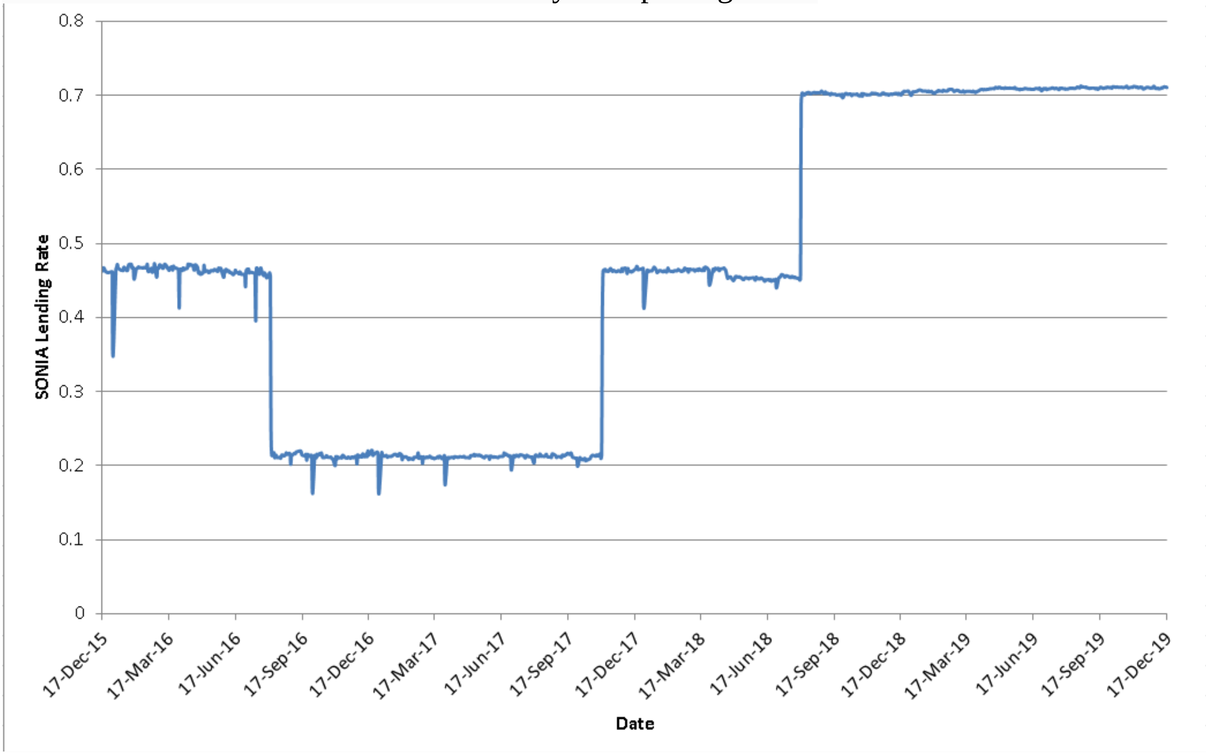
As shown in the chart below, SONIA is relatively stable except for quarter, half and year ends. These dips have disappeared in 2019 but we believe there is still a risk that they could be triggered again.

SONIA volatility on reporting dates[6]



Broader liquidity issues can be exacerbated.

Lack of appetite in the deposit and repo market at period ends means that MMFs are impelled to find alternative investments, thus narrowing their cash buffers at precisely the time when they need to be maintaining them higher. These alternative investments are typically securities which can only be liquidated and converted into cash by sale to an intermediary, usually a bank acting as dealer, broker or market maker. Since the banks expected to provide liquidity are subject to the afore-mentioned balance sheet constraints, this could add pressure on the system, further reducing the availability of cash. This is especially true in a situation where this was combined with large scale redemptions from MMFs for some reason which affected the whole market. If MMFs are unable to raise cash by selling securities to balance sheet constrained banks, this exacerbates the lack of liquidity in the system and may lead to a potential increase in

[6] Data BOE

SONIA rates. In extreme situations, lack of liquidity in the market can lead to the type of disruption seen last September in the US market.

Exogenous shocks – emergency access to place deposits directly

In addition to predictable period-end constraints, money market dysfunction can also be triggered by broader market stress and/or an exogenous shock to the system. In such an event, the ability to place overnight cash directly with the Bank of England would enable MMFs to continue to operate efficiently. Access to the Bank's balance sheet would be a backstop or emergency measure only. It is not anticipated that such access would be needed in the normal course of business i.e. outside reporting dates and barring exogenous shocks. We understand that the Bank will wish to structure any such facility in a way as to ensure that usage, impact on market functioning and SONIA volumes are limited.

Integrity of Sonia

The integrity and reliability of the deposit market impacts the calculation of SONIA. Under the current framework SONIA rates often trade below the Bank's official benchmark rate. Banks are able to pass through deposits to the Bank of England at the official benchmark, thereby making a small arbitrage. In times of stress, investors typically move into cash as the risk-free asset. In this scenario, MMFs are likely to experience inflows and therefore have a greater need to place deposits. In this dynamic, increased demand could be expected to suppress overnight and short dated interest rates. At period ends, any such decline in interest rates may not be a direct reflection of the underlying, elevated risk aversion, but rather a function of capacity constraints.

Such distortions arguably undermine the robustness of the SONIA benchmark. Removing capacity constraints would allow for a smoother pass-through of monetary policy and set an effective floor for SONIA rates (as the Fed's Overnight Reverse Repurchase Agreement Facility does in the US).

Conclusion

Allowing funds to place overnight deposits directly would 'support financial stability by allowing settlement in the ultimate risk-free asset and reducing reliance on major banks.' (Mark Carney, Mansion House speech, June 2019)

As our members do not provide payment services, we are not seeking to settle accounts through the RTGS, merely to have access to the Bank's overnight deposit facilities as an outlet when the banking capacity is limited.

MMF liquidity comes from many sources in the real economy, including corporates, local authorities, insurance companies and pension funds. These entities utilise MMFs to manage their short-term cash flows efficiently. Improving MMF operating efficiency would therefore have broader benefits to the system, ''promoting the good of the people of the UK' in line with the Bank's mission.

In the following section we have reformulated the above information to fit the suggested questions.

What are the barriers or challenges faced today?

1. Q. *What are current obstacles faced today?*

A. Regulated money market funds (MMFs) face a lack of capacity in the deposit market. Constraints can be particularly acute on reporting dates. This can lead to operational challenges for the MMFs and to temporary interest rate distortions including a potential impact on SONIA.

2. Q. *What are the root causes of the obstacles faced?*

A. The root cause of capacity constraints in the deposit market, highlighted above, are regulatory requirements. **Banks now have significantly enhanced liquidity buffers as well as much more capital. Cumulatively, UK banks now hold 65 % more regulatory liquidity than they did in 2009.** Liquidity Coverage Ratios (LCR) introduced as part of Basel III require banks to hold high quality liquidity assets (HQLA) that can be converted into cash to meet 30 day's liquidity needs.

Capacity constraints in the deposit market

Whilst LCR has improved bank resilience, the balance sheet effect has been to limit bank appetite for deposits under 30 days. Deposits less than 30 days have no balance sheet value, as they 'run-off'. Since cash investors need flexibility and bank borrowers need term money, 'transactions are overwhelmingly completed overnight', as noted in the Bank's Quarterly Bulletin Q1 2018. [7] Banks are strongly incentivised to seek longer term, more stable funding sources. The capacity for bank deposits can therefore be seriously constrained on reporting dates and/or at times of stress.

Mismatch between the requirement for MMFs to maintain high liquidity levels and the lack of incentive for banks to hold very short-term deposits.

Whilst banks have little economic or no incentive to accept very short deposits, and indeed may seek to avoid them, regulated MMFs are required to hold high levels of liquidity. This diametrical opposition between two major parties in the deposit market can lead to operational challenges for the MMFs and to temporary interest rate distortions, including a potential impact on SONIA.

As bank appetite for wholesale deposits has declined, some deposit activity has migrated to non-traditional intermediaries, including MMFs which offer cash-rich investors a scalable alternative to bank deposits. As part of their conservative risk structure, MMFs are required to maintain a certain level of cash or cash equivalent holdings to ensure a high degree of liquidity. Depending on the type of regulated fund, this translates to a minimum of 7.5 % to 10% in 'daily maturing assets' including cash

[7] BOE Quarterly Bulletin 2018 Q1 Sterling money markets: beneath the surface, Overview

deposits, reverse repo and other securities which mature, or can be recalled or terminated within one working day. Similarly, it translates into holdings of between 15 % to 30 % in 'weekly maturing assets' including cash deposits, reverse repo and other securities which mature, or can be recalled or terminated within five working days. In practice, most funds typically run much higher balances in order to ensure a comfortable buffer while also accommodating daily client subscription or redemption flows. MMFs therefore provide a valuable home for short dated cash. With over £200bn invested in short term instruments, including deposits, the funds can have a material impact on money market activity.

Investors in the funds include UK and multinational corporates, local authorities, charities, universities and other funds. MMFs, whilst aggregating and investing cash in longer term paper such as T bills, ECDs or ECP, do, in turn, need to place significant amounts of overnight deposits. Currently the only option is to do so with a bank counterparty. The Bank's 2018 analysis of SONIA showed that 71 % of SONIA depositors were funds, of which 28.2 % were money market funds.

Problems can be acute on reporting dates

Demand constraints (i.e. lack of bank appetite to receive deposits) can be particularly acute in the lead up to and on reporting dates, such as quarter ends and year ends. These periods of reduced bank appetite result in the funds having to negotiate access to commercial bank balance sheets by maintaining certain business flows during 'normal' periods. Such negotiations are informal and non-binding, *meaning that funds can still be exposed to last minute changes in bank willingness to take cash*. This element of unpredictability can be detrimental to efforts to manage a fund within the required liquidity parameters. Typically deposit demand will drop by around 20% but some bank counterparties will withdraw completely. This can also lead to distortions in interest rates. SONIA is relatively stable except for quarter, half and year ends. These dips have disappeared in 2019 but we believe there is still a risk that they could be triggered again.

3. Q. *What is most effective way to resolve the root causes of the obstacles raised above?*

    A. Allowing regulated money market funds access to Bank's overnight deposit facilities would greatly alleviate the problems highlighted above. See further detail below.

How could the ability to hold funds at the Bank, or access its payment infrastructure, help?

4. Q. How would additional access to the Bank's payment infrastructure or the ability to place funds overnight help?

A. With respect to this question, we have responded regarding access to the overnight payment facility. The payments infrastructure is not relevant to our constituency.

Widening access would be beneficial to the integrity of Sonia

The ability to hold funds at the Bank would provide an alternative for cash placement and reduce pressure on bank capacity. This would make interest rates more reflective of *risks* rather than *capacity constraints*.

The integrity and reliability of the deposit market impacts the calculation of SONIA. Under the current framework SONIA rates often trade below the Bank's official benchmark rate. Banks are able to pass through deposits to the Bank of England at the official benchmark, thereby making a small arbitrage. In times of stress, investors typically move into cash as the risk-free asset. In this scenario, MMFs are likely to experience inflows and therefore have a greater need to place deposits. In this dynamic, increased demand could be expected to suppress overnight and short dated interest rates. At period ends, any such decline in interest rates may not be a direct reflection of the underlying, elevated risk aversion, but rather a function of capacity constraints. Such distortions arguably undermine the robustness of the SONIA benchmark. Removing capacity constraints would allow for a smoother pass-through of monetary policy.

Broader liquidity issues can be exacerbated.

Lack of appetite in the deposit and repo market at period ends means that MMFs are impelled to find alternative investments, thus narrowing their cash buffers at precisely the time when they need to be maintaining them higher. These alternative investments are typically securities which can only be liquidated and converted into cash by sale to an intermediary, usually a bank acting as dealer, broker or market maker. Since the banks expected to provide liquidity are subject to the same balance sheet constraints this could add pressure on the system, further reducing the availability of cash. This is especially true in a situation where this was combined with large scale redemptions from MMFs for some reason which affected the whole market. If MMFs are unable to raise cash by selling securities to balance sheet constrained banks, this exacerbates the lack of liquidity in the system and may lead to a potential increase in SONIA rates. In extreme situations, lack of liquidity in the market can lend to the type of disruption seen last September in the US market

5. Q. *What are the characteristics of the BOE accounts which would be most useful?*

A. Our members would value the increased independence from commercial banks, the Bank's credit worthiness as lender of last resort and the ability to receive the Bank's market on deposits. These characteristics would mitigate the problems associated with lack of commercial bank capacity and the consequent distortion of interest rates which may mean those rates are a sub-optimal reflection of demand and credit risk. The unique credit worthiness of the Bank means that MMFs could readily meet their credit objective of minimising counterparty risk at the same time as avoiding capacity constraints in the wholesale market. If MMFs had the ability to place directly with the Bank, thereby receiving the Bank's market rate, they would also be less subject to sudden drops in overnight interest rates which reflect capacity constraints rather than fundamental credit risk. This could provide an effective floor for SONIA, thereby ensuring a limited impact from market technicals on the risk-free rate at period ends.

6. Q. What are the nature of the firms which would benefit?

A. IMMFA is responding on behalf of its members who are regulated money market funds. Regulated MMFs play an important role in the real economy by allowing investors to manage their cash efficiently. MMFs are used by a broad range of investors in the real economy (see above).

They offer a scalable alternative to bank deposits and account for a substantial share of the deposit and SONIA market. IMMFA members currently hold approximately £205bn in short term assets and their activity can have a significant impact on the sterling money markets

The funds deposited with the Bank would be cash held in the MMFs on behalf of their investors. The MMF would be acting as principal.

Although MMFs are not 'payment firms', we believe that the issues prompting this call for evidence are not only highly pertinent important to our members.

Q. How much roughly would you expect to hold overnight?

A. It is not anticipated that members would need to deposit directly on a regular basis, rather that the facility might be used on an exceptional basis at times of capacity constraints or stress, which are typically reporting dates.

What might be the broader implications of the Bank widening access to deposit or settlement account facilities?

7. Q. *How might widening access introduce or reduce risk?*

A. Widening access to allow MMFs to deposit overnight funds would reduce their operational and credit risk, improve the liquidity and functionality of the money markets on reporting dates to a level of efficiency consistent with normal operation, and assist in transmission of monetary policy by ensuring interest rates reflect risk appetite.

8. Q. How would access to deposit facilities change the economics of your business model?

A. Access to the Bank's overnight facility would make risk more manageable and returns on reporting dates less volatile so would be an overall economic benefit. Access would give the MMF industry the confidence to maintain their daily and weekly liquidity buffers at the desired levels, thereby limiting any broader, undesired impact on market liquidity.

What Safeguards might be necessary?

9. Q *Would safeguards be necessary?*

A What we have outlined above are problems arising from a specific dysfunctionality occurring at period ends. It is not anticipated that access would be required under 'normal' market conditions. The Bank may wish to structure any such access in such a way as to ensure usage, impact on market functioning and SONIA volumes are limited. Otherwise no safeguards are needed.

Yours sincerely,

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