THE INVESTMENT ASSOCIATION

LICUIDO

# MONEY MARKET FUNDS AND TOKENISATION:
## COLLATERAL OPPORTUNITIES

March 2024

## ABOUT THE INVESTMENT ASSOCIATION (IA):

The Investment Association champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 48% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

## ABOUT LICUIDO

LiCuido, an IA Engine member, provides a digital and technical solution to help asset management companies and other financial institutions tokenise their traditional funds. LiCuido's proven smart token technology can improve a fund's value by giving it enhanced utility and liquidity through digitisation with minimal disruption to existing process.

LiCuido aim to transform a fund's usability in terms of collateral acceptability and immediacy/settlement, thereby enabling a host of potential cost savings and efficiencies for the fund issuers and investors.

The LiCuido solution marries the tokenisation platform, third party, FCA-registered digital custody and bespoke Repo and collateral functionality – our objective is to provide an interoperable industry solution to fund tokenisation and all the immediate benefits that that brings in terms of additional liquidity to our issuers and their investors.

# INTRODUCTION

This briefing paper looks at the potential for a specific use of tokenised funds in the UK: namely, using Money Market Funds (MMFs) as collateral both in non-centrally cleared derivatives trades and the repo markets. The broader context for this use case is recent liquidity stresses in the repo and derivatives markets – notably the 2020 'dash for cash'[1] and the UK's 2022 gilt market volatility[2] – and the FCA's current consultation[3] on Money Market Fund reforms, which, amongst other things, explores the application of tokenised MMFs for use in meeting margin requirements on non-centrally cleared derivative trades.

# MONEY MARKET FUNDS AS AN INVESTMENT – WHO, WHAT AND WHY?

MMFs are a type of open-ended investment fund available in many jurisdictions. MMFs provide investors with a pooled liquidity management solution, with a diversified portfolio of low risk investments in high-quality short-term assets. They provide investors with a way to manage liquidity positions while diversifying credit risk and aiming to yield a return in line with short-term money market rates.

MMFs are an important cash management vehicle for investors seeking to manage their short-term liquidity needs, including meeting margin calls or other short term cash needs. They are particularly important for larger corporate and institutional investors such as pension funds, who have fewer alternative options for managing their cash needs, given the limit on the amount of unsecured exposure they can take to bank balance sheets through deposits.

MMFs are subject to regulation to ensure that they can redeem investors' investment and return it to them as cash at short notice: they typically offer daily redemptions, often with same day settlement.

[1] *The role of non-bank financial intermediaries in the 'dash for cash' in sterling markets*, Bank of England, 2021
[2] *An anatomy of the 2022 gilt market crisis*, Bank of England, 2023
[3] *CP23/28: Updating the regime for Money Market Funds*, FCA, 2023

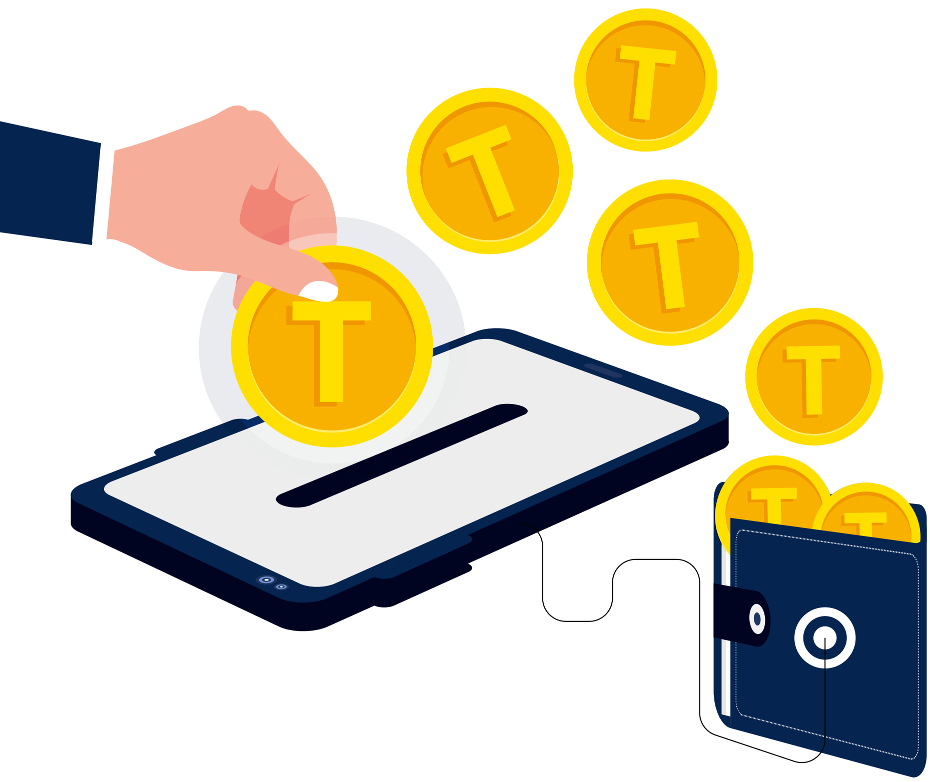
# EMERGING OPPORTUNITIES THROUGH TOKENISATION

The Technology Working Group to the HM Treasury Asset Management Taskforce (Taskforce Tech Working Group) recently set out the case for the tokenisation of UK authorised investment funds, along with a blueprint for delivering on that vision[4].

Regardless of the asset class investment funds offer exposure to, tokenisation has a number of generic operational benefits, including a simplification of the reconciliation between the books and records of the various parties to the fund and automation driven by smart contracts. The report also highlighted the potential for significant investor benefits, such as improved transferability of ownership of the units/shares of the fund (to be known as tokens), and the potential for increased use as collateral.

There is growing confidence, evidenced through recent initiatives, that tokenisation may be a particularly useful mechanism to enhance the utility of MMFs. This is in respect of operationalising the ability to use MMFs as collateral both in non-centrally cleared derivatives trades and the repo markets.

Continuing developments in digital asset markets may offer other ways in which MMFs may adapt in future, particularly as decisions are made around reliable and secure on-chain currencies, and as the regulatory framework for stablecoins and the use of central bank funds for wholesale purposes becomes clearer[5]. For the purposes of this paper, we focus on the immediate use case of the benefit of MMF tokenisation rather than the longer-term evolution of distributed ledger technology, and distinct from native digital assets such as cryptoassets.



[4] *UK Fund Tokenisation: A Blueprint for Implementation, Interim Report from the Technology Working Group to the Asset Management Taskforce,* The Investment Association, 2023

[5] *FCA and Bank of England publish proposals for regulating stablecoins,* Bank of England, 2024

# USING TOKENISED MMF UNITS AS COLLATERAL FOR REPO AND MARGIN CALLS

The post-2009 Global Financial Crisis reforms to require counterparties to post margin and collateral have mitigated counterparty risk but resulted in periodic spikes in liquidity demand. As we discuss further below, the transformation of counterparty risk into liquidity risk can be particularly challenging at moments of market stress such as the episodes in March 2020 (global 'dash for cash') and Autumn 2022 (UK gilt market crisis). Innovations such as MMF tokenisation are one way of lessening the pressure that results in such episodes.

As noted above, one of the key uses of MMFs by institutional investors is in seeking to manage their liquidity needs for the margin and collateral calls required by their investment positions. Currently this involves investors redeeming their MMF units and using the cash received to make their collateral and margin calls.

However, what if MMF investors did not have to redeem their units, but could instead transfer their ownership of those units directly to a margin counterparty as collateral?

MMFs contain many different investments. Investors own MMF units and their performance, but have no control of the portfolio's constituent parts, so pledging or repo-ing all the underlying investments is not possible.

By tokenising the Fund, ownership and rights of a fund unit can be transferred to another legal owner near-instantaneously, thereby enabling its potential to be used for collateral. Tokenised MMFs should then be seen as a High-Quality Liquid Asset (HQLA) due to the inherent credit quality of their underlying investment pool.

This would mean that ownership of the units would change from investor to their contractual counterparty, but the MMF manager would not need to sell the underlying assets in order to meet a redemption. Not only would this lead to an enhanced investor experience, but there are potentially significant positive knock-on effects for the capital markets. Regulators' concerns regarding the impact of redemptions on underlying short-term funding markets should be significantly lessened by the addition of qualifiable HQLA liquidity that tokenisation can bring.

## TOKENISED MMFS AS COLLATERAL

Initially we would foresee tokenised MMF units being deemed as acceptable collateral for GC-Repo[6], bilateral ISDAs[7] and GMRAs[8]. This initial focus on the non-centrally cleared market offers the greatest potential for adoption in the near term. Discussions with Central Counterparty Clearing Houses (CCPs) have highlighted that for centrally cleared trades, cash will continue to be preferred for collateral and margin calls for the foreseeable future. In the meantime, CCP feedback is that making progress in the non-centrally cleared market is likely to aid future adoption for central clearing.

The non-centrally cleared market in the UK is a significant one, and the industry's response[9] to the recent HM Treasury consultation[10] on the future of the pension fund clearing exemption under the UK's on-shored version of EMIR[11], suggests that non-centrally cleared derivatives will remain a significant feature of UK markets for the foreseeable future. Meanwhile, data[12] from the Bank of England suggests that only a third of gilt repo transactions are centrally cleared, highlighting that a significant portion of the gilt repo market could benefit from the proposal to use tokenised MMF units as collateral.

Of course, the Tokenised MMF units (tokens) can also be utilised in repo transactions as collateral against cash, so for those agreements, cleared or uncleared, there is the option to repo the tokens to raise cash to meet cash Variation Margin (VM) requirements or other short-term cash requirements that would otherwise involve redemption of the MMF units. VM is typically exchanged daily, and sometimes intraday, depending on market conditions. Such a frequency should naturally lend itself to tokenised assets that can be transferred more quickly and seamlessly via a DLT-based network. If MMF tokens are used to satisfy VM calls, quicker settlement timing could reduce the margin period of risk and lower the parties' Initial Margin (IM) requirements for those whose ISDAs have an IM clause.

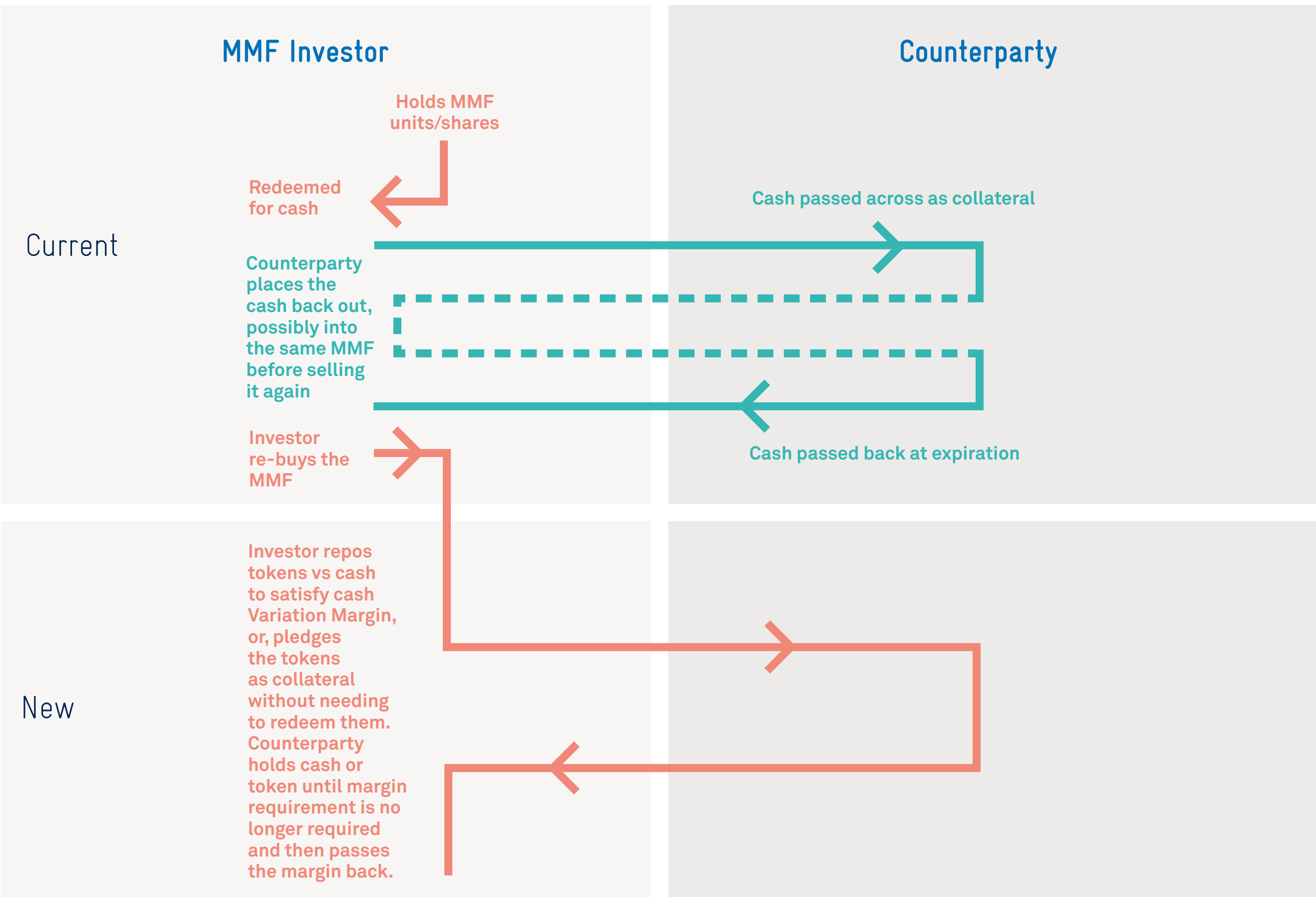
[6] General Collateral Repo
[7] OTC derivatives
[8] Global Master Repurchase Agreement
[9] *IA response* to HMT call for evidence on the pension fund clearing exemption, IA, 2024
[10] *Pension fund clearing exemption: call for evidence*, HM Treasury, 2023
[11] European Market Infrastructure Regulation
[12] Table 3 in '*The potential impact of broader central clearing on dealer balance sheet capacity: a case study of UK gilt and gilt repo markets*', Bank of England, 2023

## WHAT ARE THE BENEFITS OF A TOKENISED MMF UNIT?

The benefits to the wider financial system are clear, with MMFs less likely to be subject to large outflows if investors no longer need to sell their holdings to raise cash for margin and repo collateral. In addition, there are benefits that exist at the level of the fund manager and individual investor:

- Digitised onboarding AML/KYC/pre-qualified investors – streamlines, codifies and facilitates through efficient process
- Faster settlement and clearing significantly reduces intermediation costs of settlement agents and post trade services
- Instant collateral transfers free tied up capital during clearing and can significantly reduce intra-day exposure banking fees
- Counterparty credit risk, bankruptcy risk, and performance risk are all greatly reduced due to the shortened settlement cycle
- Collateral acceptability and subsequent usage reduces the need to hold HQLAs in reserve in case of margin calls, and therefore the resulting cash drag
- Pledging MMF tokens as collateral can avoid operational inefficiencies experienced by some firms in having to recall and replace collateral in order to reclaim income / coupons
- Reduction in issuance speed and time-to-market, wider and more diverse investor base
- Reduction in intermediation fees through efficiency

**FIGURE 1: COMPARATIVE FLOW OF ASSET ACROSS PARTIES**



## Market Stress and MMFs

In times of high market stress, investors use their cash management tools to meet margin calls on their derivative exposures and repo transactions. This leads to heightened liquidity demand at a time when markets are impaired, and subsequently, positions in HQLA are sold.

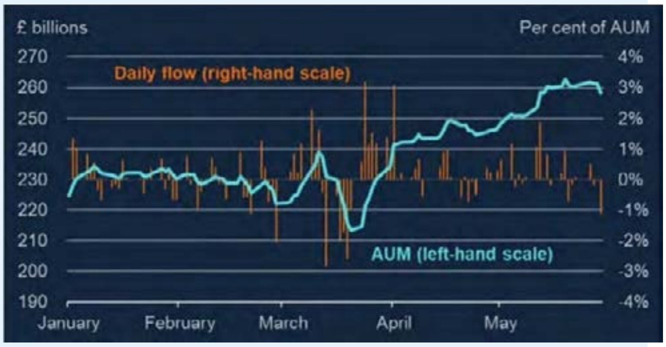
In recent years there have been two key instances where MMFs have seen redemptions increase, primarily due to market conditions resulting in investors needing to raise cash to meet margin calls:

- The onset of Covid in March 2020 created an abrupt and extreme 'dash for cash' as markets responded to the impact of the pandemic on economic activity. MMFs saw outflows as investors withdrew money to meet obligations elsewhere such as margin calls. As the FCA notes in its current MMF consultation paper "*Sterling-denominated MMFs saw outflows of around £25bn; or 11% of their total assets.. [with].. [m]arket intelligence suggest[ing].. redemptions were largely driven by investors that use derivatives seeking to meet margin calls by redeeming their investments in MMFs. These outflows were extremely large compared to previously observed sterling MMF flows*".[13]
- In September 2022, the UK government's mini-budget triggered an unprecedented large and rapid re-pricing of gilts, which resulted in UK pension schemes using Liability-Driven Investment (LDI) strategies having to post margin against the derivative and gilt repo exposures they held as part of those strategies. A concentration of pension scheme holdings in the long-dated and index-linked gilt markets created pro-cyclical dynamics, and the Bank of England felt compelled to step in as a buyer of last resort in the gilt market, in order to prevent a risk to the UK's financial stability materialising. As the FCA notes, some MMFs saw significant withdrawals as pension schemes sought to raise cash for margin calls, followed by strong inflows in the period immediately following the market disruptions as investors rebuilt their short-term liquidity[14].

The charts below, reproduced from the FCA's MMF consultation paper, illustrate the flows experienced by MMFs in these two episodes of market stress.

### CHART 1: MMFs IN RECENT PERIODS OF MARKET STRESS

**Panel 1:** £ MMF AUM and daily flows in 2020




**Panel 2:** £ MMF AUM Breakdown of daily flows 2022-2023


*Source: Bank of England, Crane Data. Reproduced from FCA CP23/28*

It is precisely these episodes that have caused regulators to become increasingly concerned by redemptions from MMFs at times of market stress.

[13] CP23/28, paragraph 2.8, FCA, 2023
[14] CP23/28, FCA, 2023

# TOWARDS MMF TOKENISATION

The Taskforce Tech Working Group's recent interim report[15] outlined a series of broader steps necessary for fund tokenisation in the UK. The baseline model set out by the Group is likely to be sufficient for the tokenisation of the MMF itself, but beyond that, an ideal solution would ensure the following requirements:

- Proper investment screening, Anti-Money Laundering (AML) and Customer Due Diligence (CDD) and secure onboarding are observed.

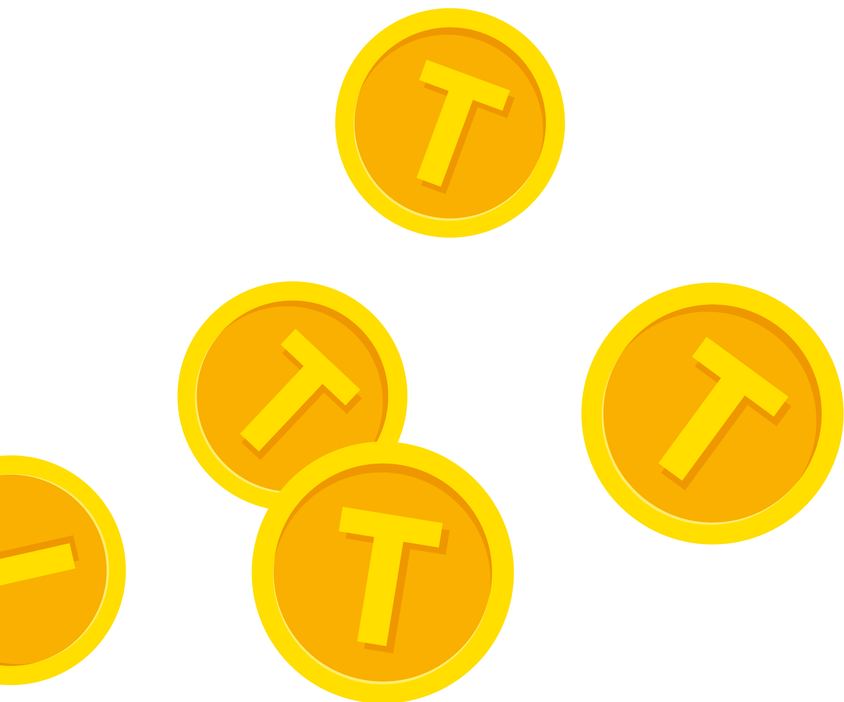
- There is legal surety that a MMF token represents one-for-one legal title to a MMF unit.

- Tokenised MMFs where the underlying investments are of a requisite credit quality and liquidity to qualify for subsequent use as collateral should then be seen as HQLA. This step may require regulators to also consider the treatment of MMF units for the purposes of Bank capital requirements. In particular, the treatment should ideally be the same as that of the underlying assets of the tokenised MMF.

- There should be no impediments to subsequent trading of MMF tokens in secondary and repo markets. Contractual language between counterparties should reflect this.

Regulatory recognition of MMF tokens would further enhance the ability of commercial banks to offer liquidity against them, even under stressed conditions. The Bank of England should expand its acceptance of Level A collateral to include MMF tokens, with appropriate haircuts, for routine use in its STR (Short Term Repo) operations. Current acceptable collateral includes Gilts and Treasury Bills, both of which constitute a significant portion of a MMF's investment portfolio. Additionally, the Bank should consider allowing MMF tokens to be used in its Temporary Expanded Collateral Repo Facility (TECRF), which can be implemented by the Bank to support market functioning in times of stress.

Central Bank collateral acceptability would both promote and endorse widespread market adoption.



[15] *UK Fund Tokenisation: A Blueprint for Implementation*, Ibid

# MMF TOKENISATION – TAKING THE INITIATIVE

The Taskforce Tech Working Group is due to publish its second interim report shortly. With the baseline model providing a firm foundation, there is both an opportunity and a strong imperative for further collective exploration of use cases such as MMF collateral.

We invite firms and stakeholders from across the industry to consider the issues raised in this paper and to get engaged. Subject to appropriate commercial and competition safeguards, the IA intends to continue to coordinate with policymakers and regulators to help advance the process of turning the concepts described here into a reality. This will be to the benefit of firms, their customers and ultimately the wider financial system as digitalisation accelerates.

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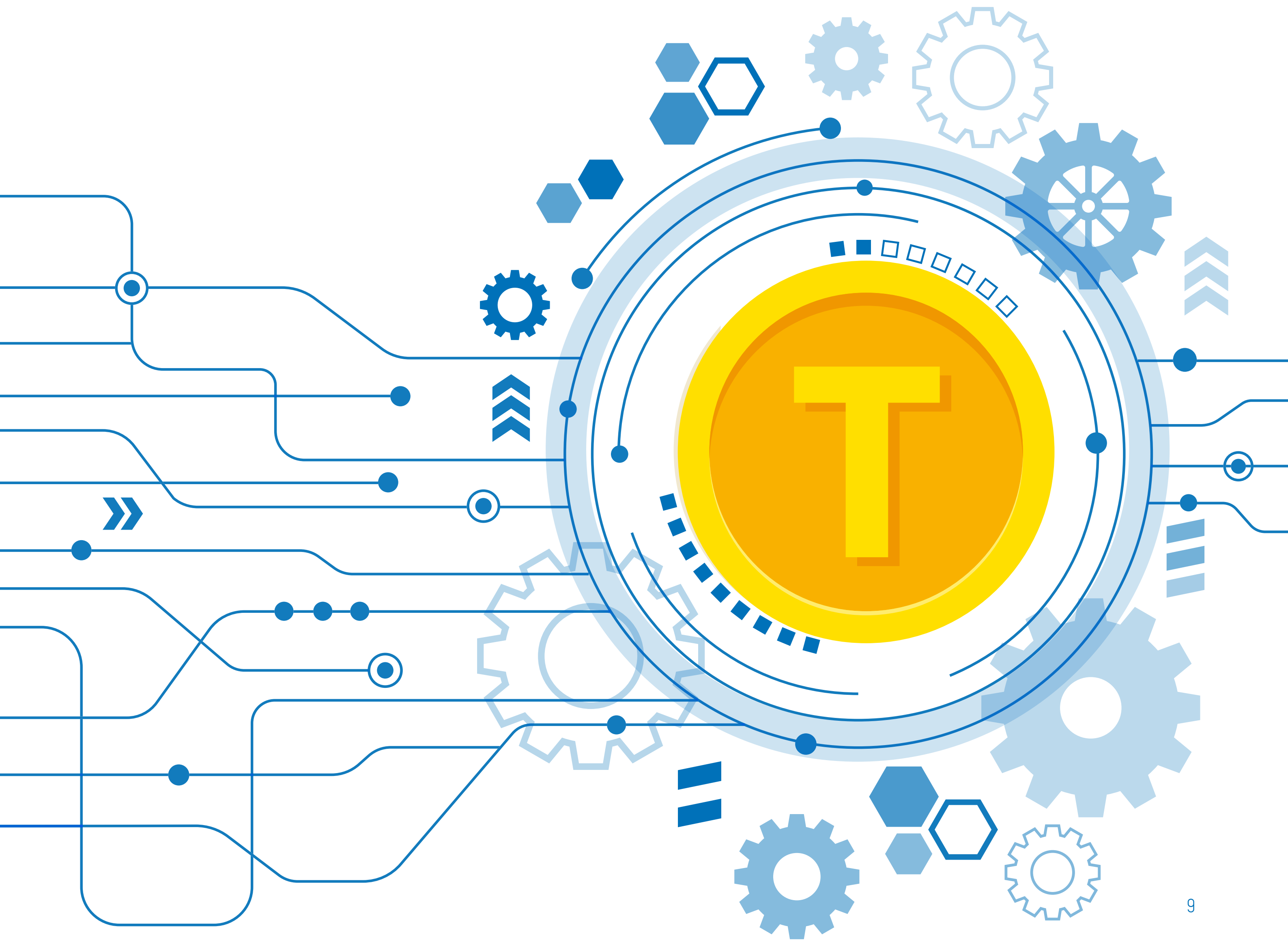

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