IMMFA
INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

The Institutional Money Market Funds Association's (IMMFA)[1] Views on The European Commission's Proposed Regulation on Money Market Funds (MMFR)

European domiciled money market funds (MMFs) provide a valuable service to investors, issuers and the 'real economy'.

- Investors: Corporations, pension funds and other institutional investors have vast liquid portfolios. They are not protected by government guarantee schemes and are very risk sensitive. They value MMFs for their credit diversification, access to professional credit management, transparency and the efficiencies they provide their day-to-day operations. In addition, the MMF assets are held in third party custodians and are not exposed to the insolvency of the MMF provider.
- Issuers: CNAV MMFs provide a small[2] but relatively stable source of cross-border funding for European banks and, to a lesser extent, companies. This funding is important given the challenges facing European banks as they deleverage coupled with the volatility and increasingly national profile of the interbank lending market.
- European companies: MMFs represent approximately 50% of all investments in Asset Backed Commercial Paper (ABCP) in Europe. ABCP improves the working capital of large companies such as Telecom Italia, Lafarge and Volkswagen. However, over 50% of the recipients of this funding are SMEs and non-rated firms that have limited direct access to capital markets, particularly in countries where banks are finding it increasingly difficult to lend to such firms. Some ABCP conduits benefit from supranational guarantees, demonstrating their importance to the economy.

Many regulators have concluded that MMFs did not cause the financial crisis in 2007/2008. The November 2012 SEC staff report[3] on MMF states that academic literature characterises redemptions from MMFs as a 'flight to quality' as many investors switched their bank credit exposure in prime MMFs into sovereign risk in Government Liquidity MMFs**.** Nervous investors reduced their exposure to bank credit during the 2008 credit crisis whether they were invested in MMFs, had money on deposit with banks or invested directly in bank debt instruments.

Nevertheless regulators remain concerned over the role MMFs played in transmitting the financial crisis via client redemptions and sponsor support. IMMFA recognizes these concerns and supports many of the provisions of the EC MMFR proposal, including that MMFs should have:

- Even greater transparency so investors have a full view of how a fund is performing;
- Minimum percentages of liquid assets that mature overnight and less than one week, which will help MMFs meet client redemptions without having to 'fire-sell' portfolio assets in secondary markets
- Minimum asset diversification limits to minimise exposure to individual issuers
- Robust monitoring of the investor base and stress testing to ensure MMFs can anticipate redemption requests in adverse market conditions

IMMFA believes that redemption gates and fees will be more effective in mitigating client redemptions than capital requirements (the European Commission's proposal).

Redemption gates and/or liquidity fees would act as a 'circuit breaker', reducing client redemptions during stressed market conditions. A redemption gate and/or liquidity fee would dis-incentivise investors from irrational flight. Clients who truly need liquidity to meet specific payments or clients who decide they want their cash could access it, but they would need to pay a redemption fee for this access in order to keep whole those investors that stay invested in the MMF. This would be equivalent to the decrease in value an investor

[1] IMMFA represents managers of European Union domiciled constant net asset value money market funds. IMMFA members are bound by a Code of Practice the objective of which is to protect investors by imposing high and consistent standards on IMMFA funds. All IMMFA funds meet ESMA's definition of a 'short-term money market fund'.

[2] CNAV MMFs represent 2% and 6% respectively of Euro and Sterling short term funding markets. The ECB concluded that "MMFs do not seem to play a sizeable role at an aggregated level in the euro area"

[3] "Response to Questions Posed by Commissioners Aguila, Paredes and Gallagher", SEC Staff Report, November 2012

would face if they were invested in a VNAV fund or if holding the debt instruments directly. Such a fee would create the opposite incentive to a first-mover advantage. The majority of CNAV MMFs already explicitly provide in their fund prospectuses for the ability to charge liquidity fees and full or partial gates. With a couple of notable exceptions, these powers were generally not used during the 2007/8 financial crisis as MMF managers feared the client reaction were liquidity funds (MMF) not to provide liquidity - redemption gates and liquidity fees endorsed by regulation would remove this stigma effect.

In contrast, capital will not address client 'runs' in a systemic crisis
Capital does not address the issue of a 'run' on a MMF (aka the bank debt held in a MMF). It might make a MMF more robust in times of modest stress but will be insufficient in times of systemic market stress. IMMFA appreciates Commissioner Barnier's explicit desire not to prohibit one type or other of MMF given the importance of MMF to the European economy. Nevertheless, the requirement for CNAV MMF to provide 3% capital[4] amounts to such a prohibition as 3% capital is very far from being economically viable for MMF managers. The provision of such a capital buffer, were it economically feasible, would withdraw circa euro 200bn - 250bn from the European economy.[5]

Potential susceptibility to client 'runs'
The objective of both CNAV and VNAV Short Term MMFs is to provide investors with security of capital and high levels of liquidity. There is no material difference between the underlying assets and therefore no greater susceptibility of runs in one type of fund or the other. A recent Fitch report[6] stated that approximately 20% of French VNAV MMFs and 30% of CNAV MMFs suffered monthly outflows of 20% or more in September and October 2008.

Valuation
IMMFA believes that amortisation is an appropriate method to value assets in a MMF[7] as MMFs buy and hold to maturity very high quality, short term assets (with typical terms of less than 90 days) most of which do not have traded market prices[8] and which mature at par. Alternative methods such as mark-to-market or mark-to-model are not superior. Indeed, requirements to reference market prices exacerbated issues during the 2007-2008 financial crisis. This is important as one of the key features of MMF for investors is the ability to access cash 'same day' – something we believe is not operationally feasible with mark to model or market to market pricing based on independent third party pricing.

The EC's MMFR proposal will have unintended impacts on investors, issuers and financial stability

- Investors. Many investors require CNAV MMFs, for example, for tax and accounting purposes, because they require intra-day payments, have a de minimis tolerance for variation in capital or require fund level ratings. Investors will probably have to place their money on deposits at banks or invest in instruments directly. They will be obliged to become much more exposed to bank credit risk – something they tried to avoid in turning to MMFs in the first place.
- Issuers. The size of the MMF market will shrink significantly, reducing the short term funding available to banks. The cost of capital for banks will increase as a result. In addition, investors generally lack the credit expertise of MMFs to invest in a wide range of banks across Europe and will tend to favour their "bank national champions" instead. This will increase their credit exposure to these institutions when they would prefer to be decreasing it. The banks will receive greater inflows of

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[4] The EC proposal for a 3% capital buffer is of a different order of scale to IOSCO's recommendation of an NAV buffer designed to compensate for the difference between the MMF's NAV (price of 1:00) and the shadow market price (generally within a range of 99.97 to 100.03)

[5] The assets under management of CNAV MMFs in Europe are slightly under euro 500bn. Applying 3% capital would require euro 10bn from European bank sponsors. As banks are geared typically between 20 and 25 times, the reduction in lending to the European economy would be in the order of euro 200bn – 250bn.

[6] Fitch Comments on EC's Proposed Regulatory Changes to Money Market Funds, 11 September 2013.

[7] Amortised cost accounting is accepted by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) as a proxy for 'fair value'. It is consistent with the accounting treatment of bank assets that are bought with the intention of holding them to maturity (FRS 5 and UFRS 9).

[8] A recent study by independent fund administrators of IMMFA funds revealed that between 90% and 100% of MMF assets are priced using "evaluated prices" rather than traded or quoted prices.

volatile, short-term institutional deposits contrary to the policy intent to create a more stable, retail, long term deposit funding base for banks.

- Financial stability. The proposal will mean that European banks will face the challenges of deleveraging with less funding from MMFs. The reduction in MMFs assets will also work against the policy intent of encouraging a more balanced system of bank and market finance in Europe. This will be exacerbated by the impact of the MMFR proposal on ABCP, a key and growing source of market funding for European companies. IMMFA notes, however, that the MMFR proposal does not address the real risk facing European banks, namely that they have to obtain most of the US dollar funding from wholesale markets, including US domiciled MMFs.

IMMFA suggests the following amendments to the European Commission's (EC) MMFR proposal.

1. Capital requirements for CNAV MMF (Articles 29 - 34). Replace the capital requirements for CNAV MMF with a regulatory requirement to implement redemption gates and fees. IMMFA strongly believes that gates and fees coupled with liquidity buffers and enhanced transparency will be most effective in mitigating client redemptions from MMFs. Gates and redemption fees also preserve the utility of CNAV MMFs for investors and thus the size of European short-term funding markets.

2. Government Liquidity CNAV MMFs. Exempt Government Liquidity MMFs from the requirement to implement gates and fees as, in times of financial market stress, investors do not 'run' from but to such MMF. Again, this preserves the utility of such MMF for investors and funding for European governments.

3. Valuation of MMF's assets (article 26). Allow VNAV MMF to value securities by mark-to-market, mark to model or (for securities under 60 days) by amortisation. This latter provision is consistent with the SEC MMF proposal and accords with the IASB 'true and fair' provisions. Other methods based on Libor and Euribor yield curves will introduce artificial volatility and fail when no market prices exist.

4. External Data Sources. Pricing data should be provided by recognised independent pricing vendors. Any model used in 'mark-to-model' pricing should be reviewed and approved by ESMA.

5. Fund level ratings (Article 23). Replace current provisions prohibiting MMF managers from seeking fund level ratings by a requirement to review three years after the entry into force of the MMFR the confidence of investors in the MMFR and whether conditions are such that MMF managers can then be prohibited from seeking fund level ratings. Fund level ratings allow investors to identify comparable MMFs on which to carry out further due diligence prior to their final investment decision. The investment guidelines of most investors in CNAV MMFs require MMFs to be rated by at least one CRA. This will allow investors time both to gain confidence in the MMFR and where appropriate to adjust their investment guidelines.

6. Credit quality of money market instruments (Articles 16 to 20). Replace current provisions and align with the requirement of IOPRs, UCITS and AIFs to carry out their own internal analysis and monitoring which must not be mechanistic.

7. Eligible securitisations (Article 10). IMMFA recommends that the provisions be amended so that ABCP conduits with both corporate and consumer receivables qualify as eligible securitisations. This will permit ABCP to continue to improve the working capital of European companies, especially SMEs and non-rated companies. The current provisions allow investment in ABCP conduits that have exposure solely to corporate consumer receivables. This effectively eliminates ABCP as an asset class for MMFs as only one such conduit exists in Europe. It also does not reflect the reality that consumer assets have a better credit track record in Europe than corporate assets.

8. Definition of daily and weekly maturing assets for short-term MMFs (Article 21). Amend the provisions to include a wider range of very highly liquid government and agency securities that are easy to buy and sell at short notice. The current definition is unnecessarily restrictive in this regard.