IMMFA

INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

The Institutional Money Market Funds Association (IMMFA) represents managers of EU-domiciled, constant net asset value money market funds. IMMFA's Members are bound by a Code of Practice (which can be found on our website) the objective of which is to protect investors by imposing high and consistent standards on IMMFA funds. All IMMFA Funds meet the European Securities and Markets Authority's definition of a 'short-term money market fund'

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IMMFA Summary Paper on Money Market Funds

Summary

European domiciled money market funds (MMFs) provide a valuable service to investors, issuers and the real economy: investors value MMFs for their credit diversification, transparency, ease of use and because they are bankruptcy remote; and MMFs provide a small but relatively stable source of cross-border funding for European banks. Whilst European banks continue to obtain most of their US dollar funding from wholesale markets, including US domiciled MMFs, regulation of European domiciled MMFs is ill-suited to address this specific issue.

Regulators have concluded that MMFs did not cause the financial crisis in 2007/2008 but remain concerned over the role MMFs played in transmitting the financial crisis via client redemptions and sponsor support. IMMFA recognizes these concerns. We believe that further transparency, liquidity buffers and "know your client" requirements, combined with, redemption gates and liquidity fees in stressed market conditions, will be most effective in mitigating the impact of client redemptions in the future. In addition, we recommend that transactions between a mutual fund and its sponsor be clearly defined in regulation and either prohibited or require explicit pre-approval.

IMMFA strongly believes that this combination of reforms meets the FSB's requirement that safeguards for stable value MMFs ('CNAV MMFs') "be functionally equivalent in effect to the capital, liquidity and other prudential requirements on banks that protect against runs on their deposits" Other potential risk mitigants – such as a restriction in the use of amortised cost accounting, the mandatory conversion from CNAV to variable NAV MMFs ('VNAV MMF') or capital - will not reduce systemic risk but will reduce significantly the size of MMF in Europe with unintended consequences for investors and issuers. European investors would increasingly turn to bank deposits, other short term investment funds and to CNAV MMFs domiciled outside Europe. The European economy's reliance and direct exposure to wholesale bank funding would increase.

1. Benefits provided by CNAV MMFs

European MMFs provide a valuable service to investors, issuers and to the real economy As noted in the European Commission's consultation document on UCITS of 26 July 2012 "MMFs are widely used by all types of investors e.g. households, corporate treasurers, pension funds or insurance companies, who regard MMFs as a "safe" short term liquid asset class for investing cash (…). They provide an important source of funding for a variety of institutions such as sovereigns, banks or companies. Active trading by MMFs is vital for liquid markets for commercial paper, short term bank debt and sovereign debt. Increased liquidity is in turn beneficial to market efficiency and leads to a reduction in the cost of capital for firms".

Investors value MMFs for their credit diversification, transparency, ease of use and because they are bankruptcy remote. MMFs invest in the short term debt of a large number of banks, governments and corporations and thereby reduce investors' counterparty concentration risk. MMFs provide investors with access to professional credit management reducing their reliance on credit rating agencies and the tendency to focus investment in "too big to fail" banks. Investors also value the improved transparency provided post the credit crisis. MMFs typically provide information as frequently as daily on many risk metrics including full disclosure of assets held in the funds. As further benefit to investors is that MMF assets are held in third party custody accounts which protect investors from the potential failure of the MMF manager, distributor and custodian – unlike bank deposits where the depositor is exposed to the balance sheet and hence potential failure of the bank.

CNAV MMFs represent approximately 50% of MMF domiciled in Europe. A large percentage of investors in CNAV MMFs require a stable NAV: in many countries, corporate treasurers prefer income rather than capital gains for operational simplicity and tax consistency; Institutional clients typically use MMFs as sweep vehicles and as part of their cash management activities, (including to make pension and payroll payments) and to make intra-day payments, for example, to meet collateral calls. They cannot wait until the price of a VNAV MMF is struck.

There are very different investment patterns in CNAV and VNAV MMFs by country. Investors in some countries strongly prefer CNAV MMFs, investors in other countries VNAV MMFs with investors in only a limited number of countries investing in both.

Table 1

Investment in CNAV and VNAV MMFs by country of domicile of investor

	AUM (€ bn)	% CNAV MMFs	%VNAV MMFs
UK	90.9	93%	7%
Germany	11.4	85%	15%
Netherlands	9.1	97%	3%
Belgium	8.0	65%	35%
France	5.4	19%	81%
Switzerland	5.3	87%	13%
Ireland	5.1	97%	3%
Luxembourg	4.9	79%	21%
Non Europe	110.6	93%	7%

Source: IMMFA, four largest providers representing over 50%of IMMFA AUM or €258 bn
Methodology: Distributing share classes represent CNAV MMFs and accumulating share classes represent VNAV MMFs

MMFs also provide a small but relatively stable source of cross-border funding for banks. This funding is important given the challenges facing European banks as they deleverage and the volatility and the national profile of much of the interbank lending market. Based on ECB, Bank of England and ICMA data[1], MMFs in total represent approximately 6% of the Euro short term funding market and 8% of the sterling short term funding market. These figures shrink to 2% and 6%[2] respectively when taking into account CNAV MMFs only. This supports the ECB's conclusion that "MMFs do not seem to play a sizeable role at an aggregated level in the euro area[3]".

Whilst European banks continue to obtain most of their US dollar funding from wholesale markets, including US domiciled MMFs, regulation of European domiciled MMFs is ill-suited to address this issue. The US dollar market is a material funding currency for European banks but they are less able to raise dollar (than euro or sterling) funding from European depositors[4]. As noted by a recent ECB Report, the 2010 MMF reforms introduced in the USA will have a durable effect on US Dollar funding conditions for European banks going forward[5]. At the same time, the USD funding provided to banks by MMFs in Europe is important to the European economy. Ultimately, the USD funding required by banks in the "Eurodollar" market is to support European and multi-national companies who operate in industries that are USD based.

2. ***Conclusion of Regulatory Considerations on the role of MMF in the Financial Crisis 2007/8***

"**MMFs should be seen more as a messenger of stress in the system rather than the underlying cause**". This is the conclusion of a recent European Economy Economic Paper, commissioned by the European Commission[6]. This view is supported by many commentators who have characterized the redemptions from MMF following the Lehman Brothers bankruptcy in September 2008 not so much as a run on MMF as a run on bank credit in general. The November 2012 SEC staff report on MMF[7], for example, states that academic literature characterises redemptions from MMFs as a "flight to quality" as many investors switched their bank credit exposure in prime MMF into sovereign risk in Government MMF. This switch occurred across all products and all markets, as a direct consequence of investors responding to highly uncertain market conditions. Nervous investors withdrew their cash from banks during the credit crisis whether they were invested through MMFs, had money on deposit or had invested directly in bank debt instruments. They did so according to their perceptions of the credit risk of the banking sector in the USA, continental Europe and the UK, which depended in part on the actions taken by the regulators in each region. More specifically, sterling and Euro MMFs saw modest outflows as the British Government quickly nationalized RBS and Lloyds and the ECB rapidly put in place liquidity lines for Eurozone banks.

[1] United Kingdom Economic Accounts, Office for National Statistics, Q3 2012; Bank of England M3 Data, November 2012; Euro Area Securities, Issues Statistics, November 2012; Monetary Developments in the Euro Area, November 2012, ECB; European repo market survey No 23, International Capital Market Association

[2] Euro denominated CNAV MMF and VNAV MMF amount to euro 85 and 400bn respectively. In contrast, the euro short term funding market is composed of: euro 1.4 trillion of short term debt outstanding (sub 1 year at issuance); euro 3.95 trillion overnight euro deposits; of approximately euro2.76 euro short term repo (sub 1 year at issuance). Sterling denominated CNAV and VNAV MMF amount to £130bn and £25bn respectively. The sterling short term funding market is composed of: £300bn short term debt outstanding (sub 1 year at issuance); £1.1 trillion sterling overnight deposits; and approximately £645bn in sterling short term repo (sub 1 year at issuance).

[3] ECB

[4] ESRB: recommendation of the European Systemic Risk Board of 22 December 2011 on US dollar denominated funding of credit institutions

[5] ECB: changes in Bank financing Matters, April 2012

[6] European Economy Economic Papers, Number 472, by London Economics for DG Economy and Financial Affairs

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

Table 2

Average Redemption from IMMFA MMFs following the Bankruptcy of Lehman Brothers			
Percentage of AUM redeemed from Prime MMFs (%)			
	Euro MMFs	**Sterling MMF**	**USD MMFs**
One week following bankruptcy	-6%	-3%	-23%
One month following bankruptcy	-20%	-7%	-40%
One year following bankruptcy	12%	10%	-24%
Two years following bankruptcy	28%	9%	-21%
Percentage of AUM redeemed from Prime and Government MMFs (%)			
	Euro MMFs	**Sterling MMF**	**USD MMFs**
One week following bankruptcy	-4%	-3%	-10%
One month following bankruptcy	-7%	-7%	-19%
One year following bankruptcy	31%	13%	-22%
Two years following bankruptcy	36%	12%	-21%

Source: iMoneyNet

3. Residual Concerns of Regulators about MMFs

Nevertheless, regulators remain concerned about the role MMFs played in transmitting the financial crisis via client redemptions, which led to "fire-sales" of MMF assets, and because sponsor support might have material consequences for the balance sheets of bank sponsors, and hence for the financial system more widely

IMMFA recognizes that MMFs experienced unusual levels of illiquidity during the financial crisis as client redemptions led to sales of MMF assets to meet those redemptions. In 2008, investors had little information regarding the holdings in a MMF portfolio. They therefore redeemed from all the MMF in which they were invested in case the MMF had exposure to a troubled security (whether it did or not and whether they needed their cash or not). Given unprecedented market illiquidity, MMFs with insufficient liquidity to meet redemptions were forced to sell longer maturity securities to raise cash. However, it is important to note in this context that most European domiciled CNAV MMFs did not experience significant levels of redemptions*: **the financial crisis resulted in only a minor increase in the value of sales relative to the value of maturities (and this primarily in US Dollar securities) as shown in Table 3 below**.*

Table 3

Sales of Assets before Maturity by IMMFA MMFs June – December 2008 EUR bn			
	Assets Resold	**Assets Matured**	**% Resold MMFs**
2008			
• June	2.4	723	0.34%
• July	4.4	775	0.56%
• August	2.2	670	0.32%
• September	16.8	690	2.37%
• October	11.1	865	1.27%
• November	7.9	821	0.95%
• December	6.4	843	0.75%

Source: IMMFA fund administrators, aggregated data for 27 MMFs

In addition, a number of sponsors provided support to CNAV and VNAV MMFs during the financial crisis. This generally took the form of a sponsor or manager purchasing an asset from a MMF at a non-market price and holding it on its balance sheet, providing a guarantee for the MMF for credit or market value losses or providing repo facilities to, or injecting capital into a MMF. Moody's records 62 CNAV MMFs received support during 2007-August 2009[8]. The majority of these cases occurred in the USA, where the SEC encouraged such support in the face of unprecedented market illiquidity, noting as recently as 2010 that "these transactions appear to be fair and reasonable and in the best interests of shareholders". In addition, as noted in European Economy Economic Papers no 712, "credit rating agencies awarded premia to MMFs with a sponsor willing to preserve investor capital through these means[9]". The headline number of MMFs receiving support may also be misleading. Many MMFs received support because individual securities were downgraded and no longer permissible under credit rating rules and not because those securities had lost money. Sponsors holding such securities to maturity suffered no financial loss. The same document also lists a large number of sponsors in Europe which provided support to their VNAV MMFs during the financial crisis both in the summer of 2007 and following the Lehman bankruptcy, culminating in the German Bundesbank and Luxembourg government and central bank announcing special liquidity assistance to MMF against collateral in September 2008.

4. <u>IMMFA Proposals to Address Residual Concerns</u>

IMMFA recognises the concerns of policy makers. We believe that the most effective means of enabling MMF to meet and manage client redemptions include: greater transparency over portfolio holdings; liquidity buffers; 'know your client' requirements; and redemption gates and/or liquidity fees. IMMFA strongly believes that this combination of reforms meets the FSB's requirement that safeguards for CNAV MMFs "be functionally equivalent in effect to the capital, liquidity and other prudential requirements on banks that protect against runs on their deposits"

- **Greater transparency** will act as a decelerator as it will stop an idiosyncratic problem from evolving into a systemic run; as noted earlier, investors redeem either because they are concerned about the underlying assets in a portfolio or because they have insufficient information about those assets in stressed markets. The lack of transparency in 2008 encouraged a flight to Government MMFs whether investors needed their cash or not. Greater transparency over MMF holdings should, in the event that a single MMF closes for any reason, allay investor's concerns about the other MMFs in which they are invested and reduce any contagion effect.
- **Liquidity buffers** will ensure that a significant amount of liquid assets are immediately available to meet client redemptions without relying on secondary market liquidity thus minimizing the need for "fire-sales". The IMMFA Code of Practice stipulates the minimum percentage of assets under management which should mature on the next working day (10%) and within five working days (20%). We would strongly recommend that such liquidity buffers be introduced as they are the first and most vital line of defence in stressed market conditions.
- **"Know your client" provisions** will require investment managers to hold higher cash buffers than set out in regulation if this is prudent considering the composition and concentration of their client base or, alternatively, to diversify further their investor base. A fund with a relatively concentrated investor based will clearly be more heavily impacted by redemptions than a fund with a more diversified investor base, all other factors being equal.
- **Investment restrictions limiting the weighted average maturity ('WAM') and weighted average life ('WAL')** of MMFs should be incorporated into European regulation. The ESMA

[8] "Sponsor Support Key to Money Market Funds", Moody's, August 2010
[9] European Economy Economic Papers, Number 472, by London Economics for DG Economy and Financial Affairs

Guidelines on MMFs introduced such restrictions in 2010 and fundamentally changed the investment management of MMFs: WAM and WAL restrictions reduce the ability of an individual fund manager to take significant risk in a MMF; they eliminate the outlier firm – such as The Reserve Fund - willing to take more risk to build market share.

- **Redemption gates and/or liquidity fees (discretionary and non-discretionary)** are further options which could act as a 'circuit breaker', and reduce client redemptions during stressed market conditions. Triggered by the Board of a fund based on objective criteria, a redemption gate and/or the liquidity fee could be imposed to disincentivise investors from irrational flight. Clients who truly need liquidity to meet specific payments or clients who decide they want their cash can get it, however, they must pay a liquidity fee for this access. Such a fee would also keep the remaining investors in the fund whole and, in this way, 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, duties & charges, full or partial gates and / or in specie redemptions. These powers were not used during the 2007/8 financial crisis – with a couple of notable exceptions - as managers were generally cautious about the potential negative implications of being a first mover. Redemption gates and/or liquidity fees (discretionary and non-discretionary) based on objective triggers and endorsed by regulation would remove this stigma effect.

In addition, IMMFA recommends that transactions between a mutual fund and sponsor be clearly defined in regulation and either prohibited or explicit pre-approval be required before such transactions can be undertaken***.*** Further, subscriptions and redemptions into a MMF by a sponsor or affiliate of a sponsor should be reported to the relevant regulatory authority.

Finally, we would urge regulators to follow a globally consistent regulatory approach towards MMFs as a significant proportion of the investors in MMFs are global.

5. IMMFA Position on other Risk Mitigants Proposed for MMF

IMMFA believes that the combination of the risk mitigants outlined above will be more effective in addressing the systemic concerns expressed by regulators than those commonly recommended, namely a restriction in the use of amortised cost accounting, a conversion from CNAV MMF to VNAV MMF and/or the use of capital

- ***Amortisation is the most appropriate method to value assets in a MMF; it is both "true and fair"***

MMF managers buy and hold investments and tend to own assets that do not have traded market prices. A recent survey[10] by fund administrators of IMMFA funds revealed that over 99.5% of assets are held to maturity and between 90% and 100% of assets are priced using "evaluated prices" rather than traded or quoted prices. The use of amortised cost accounting is accepted by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) as compliant with generally accepted accounting principles and in the EU (where it is often used as a proxy for "fair value"). It is also consistent with the accounting treatment of bank assets that are bought with the intention of holding them to maturity (FRS 39 and with IFRS 9). The difference between the amortised cost and the current market values of portfolios of appropriately managed CNAV MMFs is immaterial to investors. Restricting the use of amortised cost accounting will not result in any material benefits for clients or markets. Instead, greater reliance will be put on mark to models based on LIBOR and EURIBOR with their attendant issues.

[10] "The use of Amortised Cost Accounting by Money Market Funds" IMMFA, February 2013

- ***CNAV MMFs are not more vulnerable to a first mover advantage than VNAV MMF; conversion from CNAV to VNAV MMFs will not stop a run on MMFs in times of financial stress***

The objective of both CNAV and VNAV MMFs is to provide investors with security of capital and high levels of liquidity. They achieve that objective by investing in a portfolio of high quality, low duration money market instruments. The likelihood of investors redeeming is determined by the quality of the assets held by the fund and not the accounting procedure used. There is no material difference between the underlying assets and therefore no greater susceptibility to runs in one type of fund or the other. A conversion from CNAV to VNAV MMF will not therefore prevent client redemptions in times of market stress. The experience of VNAV MMF in Europe suggests that they were subject to severe withdrawals during 2007 and 2008.

CNAV MMFs are often equated with bank deposits and the conclusion drawn that they are subject to a first mover advantage to a similar degree. The similarities - a stable NAV and same day liquidity – are, however, superficial and the differences between banks and MMF, which concern both their legal form and economic function, far more fundamental[11.] In point of fact, the first mover advantage is weaker for MMF than for banks as first movers are less likely to secure an advantage by trying to run from a MMF. Further, the academic literature on bank runs suggests that, in the absence of a credible deposit insurance policy for MMF, temporary suspension of convertibility – that is, redemption gates and/or liquidity fees – should be the preferred option to mitigate the risk of a run.

- ***Conversion from CNAV to VNAV MMFs does not address sponsor support issues***

Some argue that sponsors of VNAV MMFs are less likely to support their funds because their investors are more readily prepared to accept losses; whereas sponsors of CNAV MMFs are more likely to provide support because investors are not prepared to accept losses and would run if losses arose. As noted above, the European Commission sponsored survey into non-bank financial institutions lists a number of cases of sponsor support of VNAV MMF as well as fund suspensions and closures.

- ***Capital provisions or requirements for the MMF to have a NAV buffer will not disincentivise investors from redeeming.***

Furthermore, a buffer of any meaningful size (above 0.75% - 1.00%) would render the economics of a money market fund potentially unviable for many money market fund providers.

6. Conclusion

IMMFA would welcome continued discussion about effective risk mitigants for European domiciled MMFs. As stated above, we believe these to be greater transparency, liquidity buffers, 'know your client' provisions and potentially, redemption gates and liquidity fees. The mandatory conversion from CNAV to VNAV MMF will not address the issues of 'run risk', sponsor support and the dollar funding risks of European banks. Both mandatory conversion to VNAV MMFs and bank like capital provisions will, however, reduce significantly the volume of assets managed by MMFs in Europe with unintended consequences for European investors and issuers.

[11] "Money Market Funds, Bank Runs and the First-Mover Advantage" by Mark Hannam and the Institutional Money Market Fund Association, January 2013 - "Money market funds share certain superficial resemblances with banks, but are different in four fundamental respects These differences concern their legal forms but also, importantly, their economic functions. Money market funds do not engage in fractional reserve banking and they do not perform liquidity creation .. It is characteristic of banks that information on the quality and riskiness of their assets is not publically available. By contrast information on the assets of a MMF is readily available…The contract between an investor and sponsor of a MMF is different. First it is an equity contract not a deposit contact…Second the contract is a contingent demand contract.."

A recent report by Treasury Strategies Report[12] found that the vast majority of CNAV MMF assets under management would not transfer to VNAV MMF but would instead be invested in bank deposits, other short term investment funds or CNAV MMF domiciled outside Europe. This reinforces the argument (see Table 1 above) that investors in a number of European countries show a strong preference for CNAV MMFs. Were CNAV MMFs prohibited, institutional investors such as corporate treasurers and pension funds would, in these countries, be exposed to more concentrated bank risk. While constituting only a small percentage of funding markets, MMFs nevertheless provide a source of relatively stable cross-border funding for banks. This funding is all the more important given the volatility of the interbank lending market and the challenges facing banks as they deleverage. Assuming that banks are not 100% self-funding, a mandatory conversion from CNAV MMF to VNAV MMF would increase the reliance of banks upon each other on another or on the ECB for funding. Prohibiting CNAV MMF would reduce the current 'market finance' option for investors and issuers and would thereby increase the reliance and exposure of the European system on bank finance.

Table 4

Treasury Strategies surveyed institutional investors managing cash portfolios in November 2012.

- Of institutions investing in European assets, 61% used CNAV MMFs only, 30% both CNAV and VNAV MMFs and 9% VNAV MMFs only.
- 44% of respondents reported investment policies, laws or other restrictions that prohibited them from investing in VNAV MMFs.
- Were CNAV MMFs prohibited in Europe, 44% of investors would discontinue or reduce their use of MMFs, corresponding to a reduction in MMFs assets under management of 78%.
- These percentages increase to 69% and 91% respectively when taking into consideration those investors using CNAV MMFs only.

These investors would turn instead to bank deposits, other short term instruments and CNAV MMFs domiciled outside Europe.

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[12] "European Money Market Mutual Funds Survey: Summary Results & Analysis" by Treasury Strategies, January 2013