IMMFA

INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

IMMFA MONEY MARKET FUNDS POSITION PAPERS

Regarding the European Commission Proposal for a Regulation on Money Market Funds

The following documents comprise a guide to the issues presented to the MMF industry by the EC's proposed Regulation

Contents

IMMFA Fact Sheet on MMF

Money Market Funds

Money Market Funds (MMF) are collective investment schemes. IMMFA funds are all UCITS although some MMF domiciled in Europe are AIFs.

Currently MMFs in Europe are obliged to meet the ESMA guidelines – either for the more broadly-defined 'Money Market Funds', or in the case of IMMFA funds 'Short Term Money Market Funds' which have more restrictive risk controls.

IMMFA MMFs adhere voluntarily to a Code of Practice which is more restrictive than the ESMA guidelines and which represents industry best practice for low-risk, highly liquid, short duration, conservatively-operated MMF which are 'cash equivalent'. IMMFA MMFs have the preservation of capital and the provision of liquidity as their primary objectives, as well as the aim to provide returns in line with money market yields.

The management Boards of MMFs owe a fiduciary duty of care to their investors; to ensure that credit and risk management, portfolio construction and what-if scenario testing are in operation and are effective; and to treat all shareholders fairly.

Issues facing Investors:

Investors value MMFs because they provide a low risk convenient instrument in which they can 'store' surplus cash. They are extremely simple and easy to use.

MMFs reduce an investor's exposure to any single counterparty by investing in the short-term debt of a large number of banks, governments and corporations. They provide investors with access to professional credit management thereby reducing their reliance on credit rating agencies. This also helps investors avoid the tendency to have their money deposited in "too big to fail" banks.

Investors appreciate the improved transparency provided by MMF post the credit crisis. MMF regularly report to investors on many different aspects of the fund, including full disclosure of the assets it holds.

A further benefit to investors is that the assets of a MMF are held in third party custody accounts. This protects investors from the potential failure of the MMF manager, distributor and custodian. In the event of a problem or failure of one of these service providers, the assets are protected solely for the benefit of the investors in the fund – they cannot be taken or borrowed to the financial advantage of the MMF provider.

By contrast, when an investor deposits money in a bank they are exposed to the risks of all the different assets held by the bank – many of which they will know nothing about. They are exposed to the balance sheet and hence the potential failure of the bank.

Risk Diversification

Only bank deposits made by individuals (up to a threshold) benefit from Government deposit guarantee schemes. Other investors such as corporations, charities and institutions have to be much more aware of the risks to which their short-term cash are exposed.

The first step is to spread the investment across different counterparties to ensure that there is no over-exposure to a single entity. If the risk is spread, in the highly unlikely event of a default amongst those counterparties, the impact of any loss is reduced.

Assessing and monitoring the quality of all these counterparties and making the various bank transfers required every day to manoeuvre money in the right places to effect payments can become operationally risky and administratively onerous quite quickly.

Money market funds solve these issues for the investor, by taking on the credit analysis, credit monitoring, portfolio construction, payments handling and provide investors with the benefit of pooled liquidity.

Issues facing debt issuers and the real economy

The short-term debt markets are an important component of the overall capital market in Europe allowing a wide range of banks, corporates, government entities and agencies access to flexible and competitively priced funding. The European Commission has the stated aim of increasing the funding by the capital markets in Europe. MMFs are a significant part of the investor base in the European short-term debt markets. Severely hampering the operation of MMF will reduce activity in the European short term capital markets pushing the cash back either into the banking system or into less visible, less regulated, potentially less European sectors of the investment management industry.

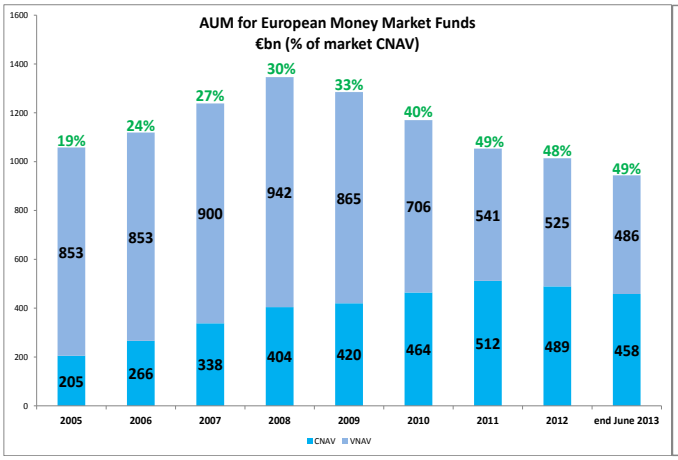
€1 trillion assets under management in European MMF

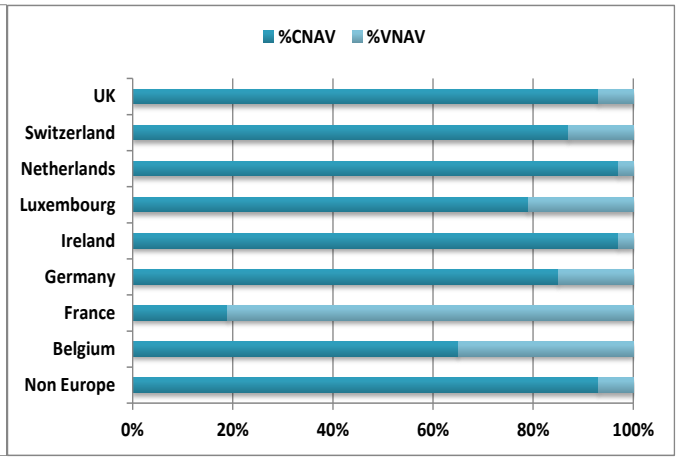
With almost €1 trillion under management, MMFs are an important sector of the asset management business in Europe. CNAV MMFs have grown steadily to represent almost 50% of MMF domiciled in Europe. At the end of September 2013, this amounted to a total of €452 billion – investors have very clearly demonstrated their satisfaction and confidence in this product.

Although the MMF industry in Europe appears to be very evenly split – 49% CNAV, 51% VNAV – most investors tend to buy either **CNAV or VNAV**; the number of investors who happily buy both kinds of fund is small.

A large percentage of investors in CNAV MMFs **need** a stable NAV; their reasons for needing or preferring to have a stable price are varied:

- CNAV funds are able to offer T+0 settlement meaning a fund can pay an investor back on the day they ask for money. This is essential for normal cash management activity, (e.g. to make pension and payroll payments).
- The investors are averse to any loss of principle.
- The ability to control an institution's cash is key to its viability.
- Institutional clients often use MMFs as a cash management tool in which to 'sweep' operational balances. This is very straight-forward when transacted at unit value.
- In many countries, corporate treasurers prefer income rather than capital gains, providing operational simplicity and tax consistency;
- Their systems have been constructed to operate with a constant NAV.





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

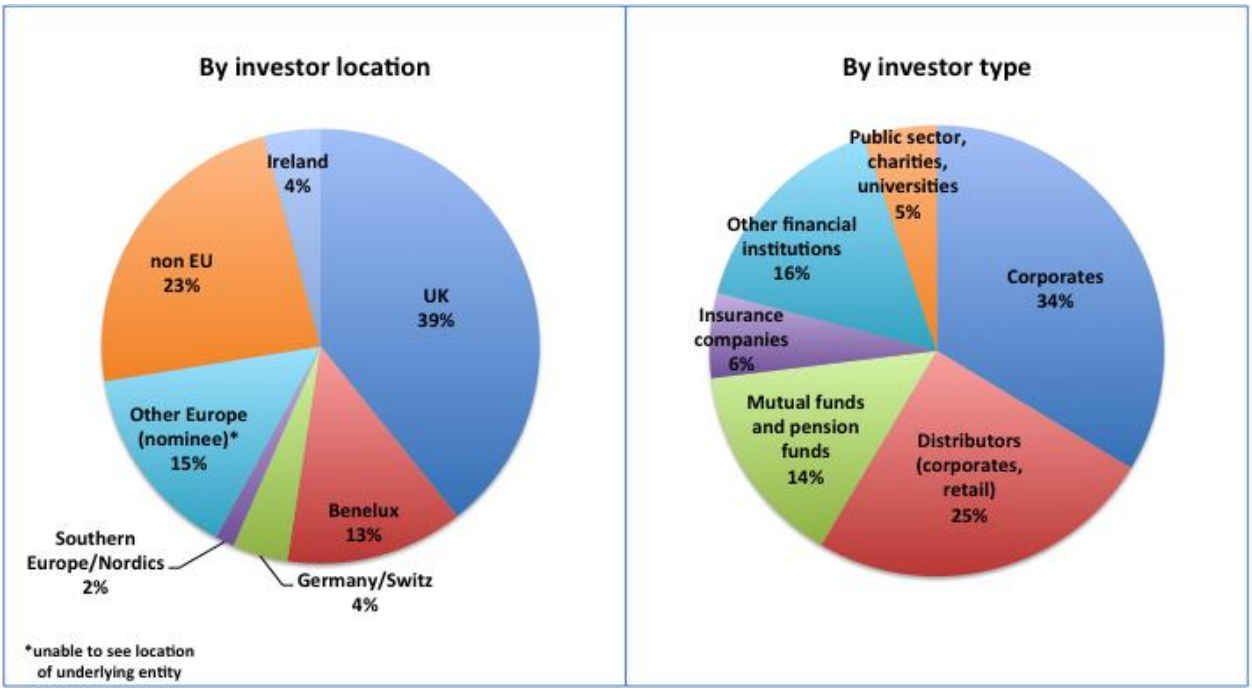
Who uses what?

The use of CNAV and VNAV MMFs varies greatly by country. Investors in some countries strongly prefer CNAV MMFs, investors in other countries prefer VNAV MMFs with investors in only a limited number of countries investing in both.

Who invests in CNAV MMF?

The investors in CNAV come from across the European Community. The largest single group of investors is non-financial corporates, but this is an important product for many different types of investor.

Investors in CNAV MMF at end Dec 2012



source: IMMFA

Net Asset Value

The net asset value (NAV) of a share of a fund is the value of all the assets added together (with any liabilities such as related derivatives netted off) then divided by the number of shares outstanding. **Constant NAV** and **Variable NAV** are different ways of working out what a share of a fund should be worth. Constant NAV funds are managed in such a way that their price, when expressed to 2 decimal places, is 1.00 (see below). They can do this because the interest or increase in value which is collected each day on every security in the fund more than makes up for any material day-to-day variation in their price. Any surplus is the yield earned by the fund that day. To help achieve this, they use amortised cost accounting.

Amortised Cost Accounting

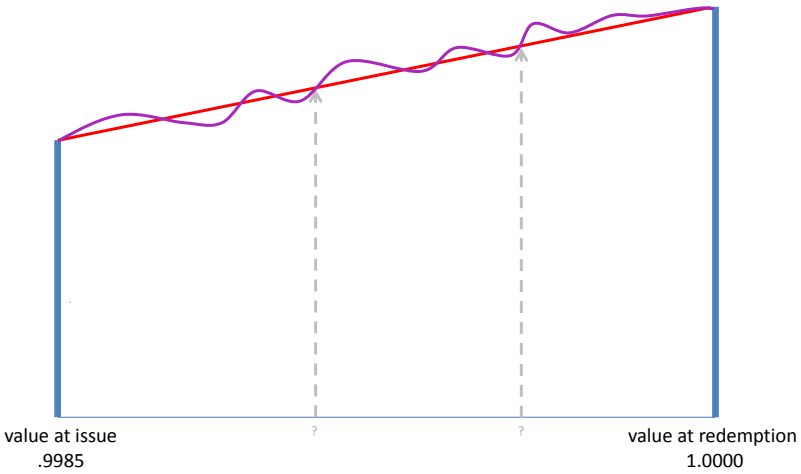
When an asset is purchased, the purchase price may be lower or higher than the price it will pay back. Both the purchase price and redemption value are known at the outset. 'Amortised cost' just means assuming that the price rises in a straight line from the purchase price to redemption price - that the increase in value from when a security is issued to when it is redeemed at par is added in equal increments each day.

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 IFRS 9)

How does a Constant NAV MMF work?

Much of the debate about CNAV MMF stems from the apparent paradox of an investment product that appears to be able to maintain a stable value. This is possible due to the types of instrument that the funds invest in and the fact that they are very low risk. They invest in instruments such as commercial paper, certificates of deposit, short-term government debt, investments in overnight deposits, call accounts and reverse repo. MMFs often buy assets at a discount and simply wait until they mature at par or invest in such a way that they maintain a face value whilst earning small amounts of interest. They invest in assets with minimal volatility in pricing. The chance of large variations in price, or even of default, of a high quality asset over a very short time scale is extremely low.

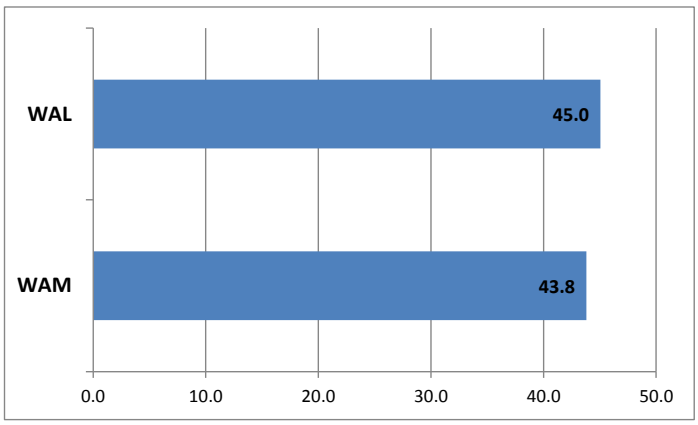
For each euro invested in discount securities, the MMF is able to purchase securities with a par or face value greater than €1. e.g. at a price of 0.9985, with €1, you would buy securities which would eventually pay back €1.0015. Every day, every asset is worth a little bit more than it was the day before.

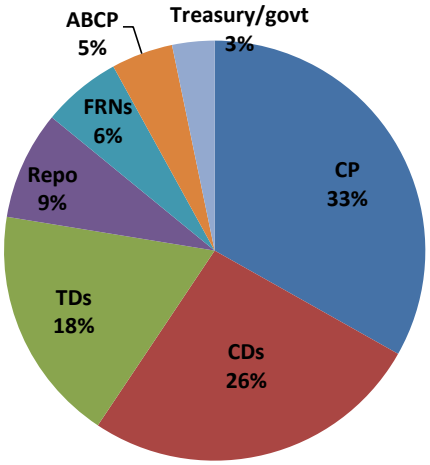


More than 99% of investments made by short-term MMF are held to maturity. The fact that not many money market instruments are traded in the secondary market is a reflection of the fact that there are very few sellers - there are always lots of buyers. The market for securities is extremely liquid – just not very active. Consequently traded prices are not always available and so an alternative method of estimating the value of the assets held must be used.

Composition of IMMFA MMF

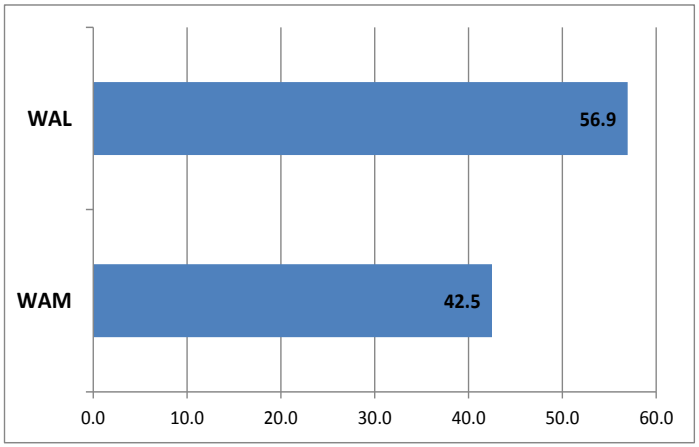
The WAM, WAL and asset composition of IMMFA Prime MMF:

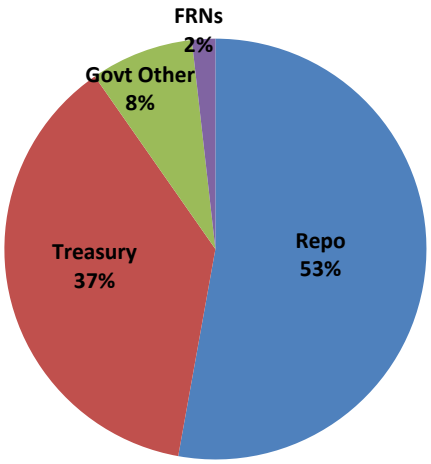




Source: iMoneynet – all IMMFA funds at 28/06/13

The WAM, WAL and asset composition of IMMFA Government and Treasury MMF:





Source: iMoneynet – all IMMFA funds at 28/06/13

The Problem with Capital Buffers

The European Commission's draft Regulation on Money Market Funds (MMFs) contains a proposal that would force constant net asset value (CNAV) MMFs to build up a 3% capital buffer (based on the net asset value of the fund) within three years.

The buffer is intended to make CNAV MMFs more able to repay redeeming investors in times of market stress without the need to sell assets - to avoid putting additional pressure on the market.

IMMFA and its members however have serious concerns with regards to the impact of the proposals on investors, the European economy and the MMF industry. We would therefore strongly encourage European policymakers to reconsider the proposals and to instead use redemption gates and liquidity fees as more appropriate means to achieve the policy objectives for the reasons set out in this paper.

Capital will not address systemic concerns around 'runs' on MMF

Academic literature on bank runs concludes that capital reserves help banks to withstand idiosyncratic problems with their asset holdings, but that capital reserves are generally insufficient to protect banks in times of systemic market stress. The two risk mitigants designed to address such conditions are:

*central bank liquidity, and *the suspension of convertibility ('bank holidays').

The same is true for MMFs. Capital reserves will be insufficient to protect MMFs from runs if the MMF investors fundamentally doubt the quality of the assets held in the MMF portfolio. In such situations, MMFs do not have access to central bank liquidity, nor should they, as they are investment products , not banking products. They are, however, able to suspend convertibility. They literally stop or slow redemptions, via redemption gates - the securities market equivalent of bank holidays – and incentivize investors to stay in the fund via liquidity fees. Indeed, the prospectuses of most MMFs already provide for such measures.

Capital for an investment product

There is no precedent of a fund provider being obliged to provide capital against a mutual investment fund. This completely confuses the understanding of the risk being taken on by the investor and is inconsistent with the Commission's proposal to prohibit "sponsor support". An investor invests in a MMF because the risk is spread across the many different assets in the portfolio. By asking the fund manager to take the first 3% loss, but also to keep topping it up should it start to be consumed, the investor is exposed to the risk of the fund manager.

Effect on the broader economy

Supposing that MMF managers were able to put up a 3% capital buffer, the impact on the broader economy and on bank lending would be significant.

The assets under management of CNAV MMFs are circa €450 billion. Applying the proposed 3% buffer would require a total of just under €14 billion of capital to be set aside. €4 billion of this would be needed from non-bank MMF sponsors and the balance €10 billion from bank sponsors.

However, banks in particular are constrained by the amount of capital they have available, so if they were obliged to put €10 billion on deposit as a buffer for CNAV MMFs, that amount could not be put to work in the economy. This effect would be further amplified as banks are geared typically between 20 to 25 times, resulting in a reduction of lending to the economy of €200 to €250 billion.

A capital buffer will eliminate CNAV funds

Fund managers, like any other business managers, need to earn a reasonable return in order to be in business. In the asset management business, the expected return would be at least 10%. In order to earn a 10% return on a 3% capital buffer, the fund would have to generate a return, net of all other expenses, of 0.3% or 30 basis points (10% x 3% = 0.1 x 0.03 = 0.003 = 30 basis points).

Currently, the net fees earned by a fund manager on a MMF are typically 8-10 basis points and it seems unlikely that investors would bear a level sufficient to allow fund managers to earn an adequate return on a 3% capital buffer.

Beyond this, the 3% capital buffer might lead to the MMF provider being deemed to have a 3% economic interest in the MMF. If so, the MMF will have to be consolidated on the balance sheet of the MMF provider. Both the 3% cash buffer and consolidation might be subject to regulatory treatment, the latter requiring up to 8% of the MMF assets under management to be injected in the form of Core Tier 1 (CT1) capital. Thus, the actual amount of CT1 capital required will be 3% as a minimum but could be over 8%. This is likely to increase CNAV MMF providers' resolve either to close their CNAV MMF or to convert to VNAV.

Further, IMMFA members are concerned that capital placed in a 'Reserve Account' with a credit institution may in the future be subject to 'bail in' under the Bank Recovery and Resolution Directive were that credit institution to enter into resolution. If so, the Reserve Account would create significant single counterparty risk and the potential for loss of principal for the MMF provider. It would also undermine the benefits of diversification offered by MMFs to their investors.

Impact on Investors

CNAV MMFs have been created to meet investors' demands and needs. Investors use such funds primarily for cash management, and rely on having full, liquid, and predictable access to their investments on a daily basis. Adoption of the Commission's proposals would fundamentally change the MMF industry, essentially eliminating a type of investment product that is well understood by investors and meets the demands of their day-to-day cash management operations. Further, it would mean a loss in return should MMFs attempt to build up buffer via retention of interest.

Convergence around VNAV MMFs will not address systemic concerns around 'runs'

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 prevent client redemptions in times of market stress: systemic risk will not have been reduced by that conversion and the presumption that VNAV investors are more content to take losses than CNAV investors is nonsensical.

Recommendation: Redemption gates and liquidity fees are the most effective way of mitigating runs on MMFs

Instead of a capital buffer, IMMFA recommends redemption gates and liquidity fees as better suited means to mitigate runs on MMFs. They should be triggered by the fund's Board and be based on objective criteria set out in regulation. They can be imposed to disincentivise investors from flight.

Fund managers have a responsibility – known as fiduciary responsibility – to treat all the investors in a fund fairly and equally. Redemption gates and/or a liquidity fee are methods by which a fund manager, if experiencing difficulty due to extreme market circumstances, can control redemptions in order to ensure that all investors are treated fairly and that no 'first-mover' advantage exists.

Clients who truly need liquidity to meet specific payments or clients who decide they want their cash can access it. However, they must pay a liquidity fee to ensure that all those investors who remain in the fund are no worse off because of the actions of the redeeming investor(s). This is equivalent to the decrease in value an investor would face if they were invested in a VNAV fund or if holding the debt instruments directly.

In this way, the liquidity fee creates a last-mover rather than a first-mover advantage, rewarding those who remain invested in the fund. Properly constituted, a liquidity fee will act as a circuit-breaker – a decelerant and not an accelerant of client redemptions.

The Use of Amortised Cost Accounting

The European Commission's proposed Regulation recommends (article 26) that where possible, assets should be valued by marking them to market.

Why is it often not possible to use mark-to-market for MMF assets?

Money Market Funds (MMFs) are portfolios of money market and fixed income instruments with extremely short maturities – such as commercial paper, certificates of deposit, short-term government debt investments in overnight deposits, call accounts and reverse repo.

MMFs closely monitor their ability to be able to sell any of the investments held by the fund back into the market by monitoring trading in the markets and obtaining estimations of the market value of their portfolio. Even so, more than 99% of their investments are held to maturity.

This is broadly true for the majority of investors in the short-term debt markets – including those which are not MMF. This means the amount of paper traded on the secondary market, i.e. assets sold and bought again after their initial issuance, is a fraction of the amount of primary issuance.

This means that often there is no easily recorded price or quote for a specific money market security - in contrast to the relative ease of publishing prices for equities or longer dated fixed income instruments which are often quoted for resale/purchase. The main fund administrators have confirmed to IMMFA that they are simply not able to source estimations of value on this basis for MMF assets in the way that they are able to for, for example, funds investing in exchange traded equities.

Currently, all CNAV MMF use amortised cost accounting. The majority of VNAV MMFs also use amortised cost accounting for assets with a maturity of less than 90 days.

Mark-to-model?

A mark-to-model valuation is only ever an estimate based on a view of current market conditions. Commercially available independent price-modelling services, as commonly employed by IMMFA fund managers to act as their price check on their shadow NAVs, take account of the market conditions at the time of valuation, but all employ a certain amount of subjectivity. It is impossible for third party pricing agents to provide totally reliable market-trading based comparators and valuations for the money market assets predominately held by MMFs. It is only possible for them to estimate the market value of a small proportion of the assets by sourcing indications of trading prices from market dealers.

The weaknesses and subjectivity inherent in these systems become more significant in stressed market conditions.

What is Amortised Cost Accounting?

When an asset is purchased, the purchase price and the redemption value are known. The time span between them is short. 'Amortised cost' is simply the assumption that the value rises in a straight line from the purchase price to par or redemption value - that the increase in value is added in equal increments each day. This is a fair and accurate approximation when used for very short maturity and high quality money market assets. There is no subjectivity or human input in using this method of estimating the value of an asset.

Why is it important?

One of the most valuable features of a MMF to an investor is the fact that funds can be redeemed 'same day' or 'T+0'. The key characteristic of amortised cost accounting is the short-term predictability it gives to the value of a fund. Because the price changes in equal increments, at the beginning of the day, the fund managers knows how the value of each asset will vary during the day.

If a VNAV fund is running on true mark-to-market or mark-to-model pricing, the fund manager cannot know the NAV at which it will be able to redeem shares until trading in the assets held by the fund has ceased for the day. The key difference being that instead of always having unit values, in theory a variable NAV needs to be known before redemptions can take place.

Some VNAV aim to address this problem by having a NAV based on 'stale' pricing – prices established the day before – but clearly this system is flawed in a stressed market. However, to date the majority of VNAV have used amortised cost accounting to give additional certainty to the determination of the VNAV.

Is Amortised Cost Accounting used in other markets?

Amortised cost accounting is widely used to evaluate assets and is recognised in the code of International Accounting Standards under IAS 39 (http://www.iasplus.com/en/standards/ias/ias39). It is regarded by the Financial Accounting Standards Board (FASB) as compliant with the generally accepted accounting principle to value money market instruments at their purchase cost plus or minus the differential between this and the redemption value evened out over the period from purchase to maturity at par, in other words - amortised cost accounting. In the EU 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 IFRS 9).

Amortised cost accounting is a very useful tool to provide clear and fair valuation and it is particularly effective and accurate in the valuation of short-term high credit quality debt instruments. Issues of fairness and clarity of valuation only arise when amortised cost accounting is applied to instruments that have a longer final maturity than their exposure to interest rate movements.

Money market funds are permitted to utilise this technique[1], provided the overall portfolio valuation does not diverge by more than 0.5% from the estimation of the trading valuation.

Recommendation

MMFs should be allowed to continue to use the amortised cost valuation method for permitted assets.

The use of this valuation method should be conditional on compliance with all other regulatory controls and the estimation of market value of the investment portfolio not diverging from the amortised cost valuation by more than 0.5%.

[1] **The use of amortised cost accounting by money market funds – IMMFA – January 2013**
http://www.immfa.org/publications/policy-positions.html

Definition of Liquidity Requirements

- The liquidity of an MMF represents its ability to convert assets into cash at short notice in order to meet the redemption demands of investors. The Commission has therefore proposed minimum liquidity requirements to ensure that MMFs are able to do this – which IMMFA supports.
- Inappropriately calibrated liquidity requirements risk harming the trading activity of certain products and some small changes to the proposed regime are therefore necessary to ensure it functions effectively.

What is liquidity management and why is it important?

Liquidity management is about having access to cash to be able to spend what you need to when you want to. In the context of a MMF, this means being able to convert fund assets into cash at short notice in order to meet investor redemption demands.

IMMFA supports the Commission in prescribing the level of liquidity available in a MMF. This is one of the most useful and important ways of ensuring that MMFs are able to withstand unexpected large redemptions and therefore ensure financial stability and limit the transmission of market stress

How do MMFs manage liquidity?

MMFs manage liquidity by:

- Holding investments maturing the next day or in the next few days.
- Establishing a pattern of investment maturities such that the daily maturing assets are regularly added.
- Having the fall-back of holding some extremely liquid assets in the portfolio– such as top-quality government debt - which can be sold into the market to generate additional cash in the event this becomes necessary.

What has the European Commission proposed?

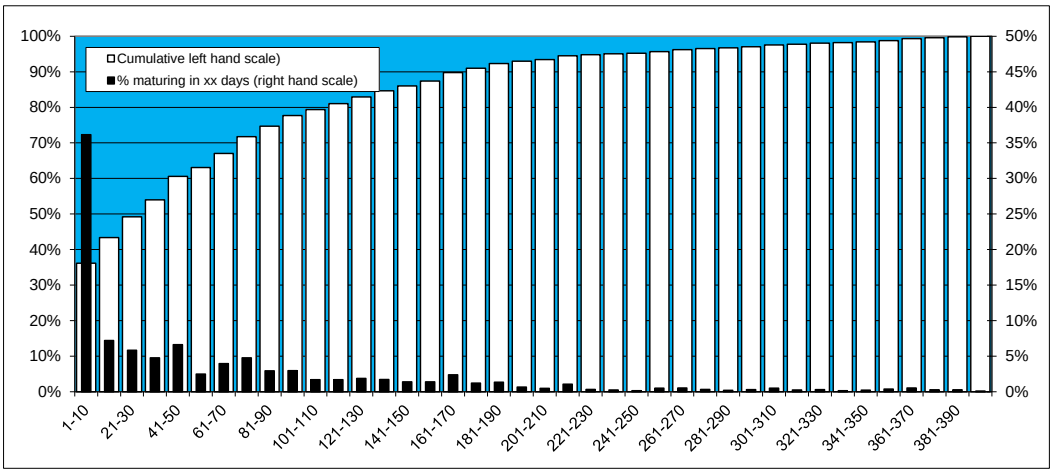
The Commission has proposed that a minimum proportion of a MMFs assets (10%) must mature in the next day and a minimum proportion must also mature in the next week (20%). IMMFA supports including these requirements in the Regulation. They already exist in the IMMFA Code of Practice.

The Commission also requires that the weighted average maturity (WAM) of an MMF should be not more than 60 days for a short term MMF (6 months for a MMF) and the weighted average life (WAL) should be no more than 120 days for short term MMF (12 months for a MMF). These are indicators of the duration of the fund. Most CNAV funds comply with the short term MMF requirements.

How do IMMFA MMFs currently manage their liquidity?

The chart below demonstrates that IMMFA MMFs are already extremely liquid.

Maturity profile of all IMMFA MMF at end April 2013



Source:IMMFA

Recommendations: What changes need to be made?

Very Highly Liquid Securities- such as government and high quality government agency securities that are easy to buy and sell at short notice should be included in the relevant short-term maturity calculation – i.e. if an instrument can be sold for same day value – e.g. a German Bubill – it can be included in the 'daily maturing assets'. If it can only be sold for settlement on a T+2 basis (the fund receives the proceeds of the sale 2 days later), it could be included in the 'weekly maturing assets'.

Some types of debt securities, such as those issued by high quality governments, sovereign or supra-sovereign agencies are always easy to buy and sell. They have the most investors because of their lack of credit risk and this makes them a very safe and attractive investment, particularly at times of uncertainty.

It makes sense, both for the issuers of the debt as well as for MMFs, that these highly liquid securities should be included as 'daily maturing assets' or 'weekly maturing assets' as even in difficult market conditions, these securities can be liquidated at very short notice to generate cash in order to repay redeeming investors. The IMMFA Code of Practice already includes them in the liquidity calculation.

Securities with variable redemption dates –It should be clarified that for a debt security where the investor can choose the date upon which he is repaid, the 'maturity date' should be the earliest date upon which redemption request can be settled. This is often known as a 'puttable' security.

In a standard debt security, the issuer and the investor agree in advance when the security will redeem and on this day the issuer repays the investor. However, sometimes a debt security is designed in such a way that the investor can decide (within a given range) when he wants to be repaid. This creates flexibility for the investor.

Given that it is entirely the investor's decision (in this case the MMF) and the issuer cannot refuse to repay IMMFA believes that the maturity date for inclusion in the limits for 'daily maturing assets' or 'weekly maturing assets' should be the earliest date on which the investor may, under the terms of the security, redeem the security, in much the same way as is allowed under the current ESMA guidelines.

Fund Level Ratings

1. How do fund level MMF ratings work?

The Credit Rating Agency (CRA) demands that MMFs meet stringent credit, liquidity, diversification, governance and other requirements in order to be triple A rated. The CRA then monitors daily, weekly and monthly adherence to these requirements and carries out an in-depth formal review of the MMF on an annual basis to decide whether to maintain the triple A rating for the MMF.

Institutions such as corporations, pension funds, local authorities and charities, do not benefit from government deposit guarantees and therefore have to be more sensitive to credit and liquidity risk in managing their liquid investments. Such institutions do not typically have credit analysis expertise and so consider the opinions of third party credit agencies when reviewing MMF options. The MMF level rating allows end investors to identify comparable MMFs on which to carry out further due diligence prior to their final investment decision. It also allows investors to contrast the performance of MMFs with baseline requirements in terms of liquidity and credit management. Finally, the CRAs provide a level of independent monitoring and analysis that investors are often unable to perform.

2. Why are most CNAV MMFs rated by CRAs in Europe?

CNAV MMFs developed rapidly in Europe following the failure of Barings & C^{o} in 1995 in which many investors were faced with the possibility of losing their deposits and unsecured investments. Consequently, investors wanted a diversified investment in a mutual fund structure (where investments are held by third party custodians) and to have less exposure to the balance sheet of any individual bank.

At that time no MMF regulation existed in Europe and so, in seeking some external indication of the conformity or overall approach, investors required MMFs to be rated as a minimum independent 'quality standard'. In contrast, many of the criteria set out by CRAs have been specified for decades by Rule2a-7 under the Investment Company Act of 1940 which regulates MMFs in the USA. As a result of this historical development, over 98% of CNAV MMFs are rated in Europe compared to 60% in the USA.

In addition, the investment guidelines of a significant majority of institutional investors in CNAV MMFs – which are approved by the boards of corporations and trustees of pension funds - require MMFs to be rated by at least one and often two CRAs in Europe.

3. What is the European Commission proposing and why?

The EC is proposing that MMF providers are prohibited from seeking a fund level rating (Article 23) as well as prohibiting MMFs from referencing the ratings of CRAs in their own portfolio management processes (Articles 16 to 20 - see IMMFA paper entitled "Credit Process and Internal Rating Scale"). The objective of the fund level prohibition is to prevent a downgrade in the rating of a single fund causing an investor 'run' on all MMFs. The PrimeRate MMF was placed on Rating Watch Negative by Fitch on 7th Dec 2011 leading to the redemption of 50% of its assets in the subsequent week (but without contagion to other funds).

4. Implications for MMF clients and financial stability

The prohibition of fund level ratings coupled with MMF providers being prohibited from referencing CRA ratings in managing the MMF will hit the investors in MMFs hard. MMF clients will no longer have an external barometer by which to judge the quality and liquidity of MMF holdings and the requirements for internal ratings will lead to greater inconsistency and less comparability across MMFs for clients. Based on discussions by IMMFA members with their investors, IMMFA believes that a significant proportion of clients will no longer invest in MMFs, either because their investment guidelines prohibit investment in unrated MMFs or because they feel uncomfortable investing without the benefit of any independent CRA opinion or monitoring.

IMMFA believes that concerns over MMF downgrades are misplaced and counterproductive in terms of systemic risk.

- The reality is that MMF rating changes are almost unprecedented. Where they have occurred, they have been related to the specific circumstances of individual firms and have had no systemic impact. The clients in a downgraded MMF will simply gravitate to other MMFs as happened in the case of PrimeRate; there was no contagion to other funds.
- Clients will instead invest in bank debt and, to a lesser extent, short-term debt instruments (both rated) instead of MMFs (unrated). As a result, 'national champion' banks will receive greater inflows of volatile, short-term institutional deposits contrary to the intent of CRD IV to create a more stable, retail, long term deposit funding base for banks.
- Finally, the amount of assets managed by MMFs will shrink significantly, working against the desire of many policymakers to stimulate a more balanced system of bank and market finance in Europe.

5. IMMFA Recommendations

- If concerns about CRAs persist, the European Parliament might like to consider whether amendments to CRA III are required to address such concerns at source rather than penalising European corporations, pension funds, venture capital firms and other institutions.
- Many European investors in MMF draw a degree of confidence from ratings and may do so in time from regulation. However, it will take a number of years for investors to develop such confidence that the MMFR regulation is robust and for them to amend their Investment Guidelines. IMMFA therefore recommends that Article 23 be revised to review three years after the entry into force of the MMFR the issue of fund level ratings.

Credit Process and Internal Rating Scale

1. What is the European Commission's objective?

The European Commission (EC) is seeking to avoid a mechanistic reliance on credit rating agency ("CRA") ratings. It is also concerned that, for those funds that are rated, if a CRA downgrades a security, all money market fund ("MMF") managers who hold the security would be forced to sell the security causing problems for that issuer and potentially the financial system ('cliff effect'). To avoid this, the EC proposed that external CRA ratings should not be referenced by MMF managers in their investment process.

The EC proposal prescribes a standard internal rating scale for all MMFs. However, the criteria for determining ratings on that scale will be determined by each MMF manager individually based on metrics derived from their individual experience and information sources.

2. What happens today?

The ESMA MMF Guidelines and CRA Rating requirements define the broad universe of potential MMF eligible securities by specifying the minimum credit rating for individual securities allowed in a MMF portfolio, for example ESMA requires that Short Term MMF invest in securities rated at least the lowest of the two highest available short-term credit ratings.

These requirements only represent the starting point for MMF managers. Each MMF manager has a person or team ('credit analysts') whose job it is to carry out detailed reviews of the wide universe of issuers and securities in order to identify the very much smaller number of issuers suitable for the MMF 'Approved List'.

MMF portfolio managers can only invest in the names and tenures specified on the Approved List. It is best practice for those responsible for selecting and monitoring issuers and securities for the approved list to be separate from the portfolio managers who construct the MMF.

This review is very far from being mechanistic. Indeed, the analysis and monitoring forms the core of the MMF proposition to clients as this determines the quality and liquidity of the MMF, reducing risk for the end client. The analysis is as much an art as a science, with qualitative factors (such as an assessment of a firm's competitive position, its management quality and definition of downside risks) preponderant in most companies.

The most effective MMF credit processes are simple both in their analysis and in their verdict (that is whether an issuer is acceptable or not for a MMF portfolio). The effectiveness of internal analysis by MMF managers is shown by the fact that issuers are almost invariably removed from MMF Approved Lists a comfortable time period before they are downgraded by CRAs.

3. What are the concerns with the EC proposal?

IMMFA wholly agrees that the analysis and monitoring carried out by MMF managers must not be mechanistic. However, we believe that the internal rating scale proposed by the EC is inappropriate for MMFs and the approach runs counter to the philosophy of liquidity fund management:

- The rating scale proposed for MMF is that required for decades by prudential regulators of banks, namely to 'bucket' their very disparate loan books (retail mortgages, unsecured retail loans, corporate loans, from SMEs to national champions, shipping, infrastructure debt etc.) into six different relative risks of default and one for defaulted assets.

- Compared with bank loan books, asset management portfolios investing in debt capital market instruments are much more homogeneous - and the differences between eligible assets permitted for MMF are marginal. The 'six + one' bank loan rating system is simply infeasible for MMFs.
- The proposed approach also runs counter to sound MMF liquidity management. The EC proposal reflects a bank credit approach, whereby banks take a longer term credit view (over several years), focused on the solvency of the entity and based on an analysis of relative probabilities of default.
- In contrast, a robust MMF approach is anchored in a short-term view (less than 13 months for Short Term MMFs) of an entity's liquidity (not solvency), on the possibility of a downgrade (not default) and is binary not relative. This is because the ability of a MMF to meet client redemptions depends on the liquidity rather than the solvency of the issuer and the probability of default of investment grade commercial paper or time deposits within a MMF investment horizon is de minimus[2]. Finally, MMF credit analysts ask themselves "do we believe that this issue will be downgraded below, for example, A1/P1 within x months". The approach is binary: if the answer is 'yes', the issuer is not included on the Approved List.

4. Potential implications of the EC proposal for the end investor?

Judgment forms the core of good credit analysis, whether of MMFs or other asset management portfolios. IMMFA fears that the EC proposal will increase the focus of MMF managers on quantitative analysis to the detriment of qualitative analysis – unintentionally making such analysis more and not less mechanistic.

In addition, prohibiting reference to CRA ratings will reduce the safety of the MMF for the end investor as the CRAs are recipients of material non-public information on issuers, such as future financing plans, to which MMF managers quite rightly are not privy.

Further, eliminating CRA ratings combined with the complexity of the proposed rating scale, will lead to less consistency and comparability across MMFs. MMFs will be able to invest in a far broader universe of securities than today – leading to more disparate results, especially given the far larger number of MMF managers than CRAs. We note that little comparability exists today across bank loan portfolios despite the load rating scale now proposed for MMFs being in place for decades.

Without an external barometer, such as a fund level rating (see IMMFA paper (page xiii) entitled 'Fund Level Ratings' commenting on Article 23 of the MMFR) and in the absence of substantive comparable risk information provided by CRA ratings, the only way for clients to differentiate between MMFs will be relative yield. This will put pressure on MMF managers to reduce investment standards to garner more yield and be regarded by MMF clients as a retrograde step.

5. IMMFA Recommendation

IMMFA agrees that MMF managers must carry out their own internal analysis and monitoring and that this must not be mechanistic. We recommend that the MMFR provisions be aligned with those of IORPs, UCITS and AIFs in requiring a manager of a MMF to employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio of an MMF and to not solely or mechanistically rely on credit ratings issues by CRAs[3].

[2] Moody's statistics show that on average between 1983 and 2012, only 0.25% of short term commercial paper rated P1 at the beginning of the year is downgraded below investment grade by the end of the year (of which only a fraction has defaulted).

3 DIRECTIVE 2013/14/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of over-reliance on credit ratings

Reverse Repurchase Agreements ('Reverse Repo')

1. Summary

MMFs use reverse repo as a secure means of investing cash from the portfolio, receiving high quality collateral in return and thereby reducing their bank deposit risk. The vast majority of reverse repos are overnight transactions, that is, the exposure of the MMF to the reverse repo counterparty is also overnight and the risk of default is minimal. Nevertheless, MMFs use rigorous counterparty and collateral management processes to reduce further credit risk. Collateral management programmes are run in parallel to the investment process, typically by specialised third party agents and not by the MMF's portfolio manager.

The European Commission's proposal requires MMFs to aggregate the risk exposure of the collateral with that of the securities held within the investment portfolio. This is operationally impossible for MMFs to implement and effectively means that MMFs will no longer be able to use reverse repo for managing liquidity. The use of collateralised lending (reverse repo) over unsecured deposits (bank deposits) to ensure liquidity within portfolios should be preferred in regulation because it lowers the risk of loss for investors.

2. Why do MMFs use reverse repo?

A repurchase transaction is an agreement to sell a security, or portfolio of securities and subsequently buy it back at an agreed price. The terms of the sale and the repurchase (repo) are both agreed at the same time, as a package and incorporate the rate of interest which will be paid for the loan of the cash.

MMFs lend out cash to high quality counterparties on an overnight basis in exchange for high quality collateral (typically government and agency securities) to reduce the MMF's exposure to bank credit.

- The investment mandates of Government Liquidity MMFs do not permit exposure to bank deposits. As government bonds do not mature every day but on weekly and monthly dates set by the auction process, reverse repo is required for Government Liquidity MMFs to provide liquidity on a daily basis to meet investor redemptions; without reverse repo, Government Liquidity MMFs would have to sell their investments in government bonds before maturity to meet investor redemptions.
- Reverse repos therefore perform the same role of providing daily liquidity for government liquidity funds as overnight bank deposits do for Prime MMFs (MMFs that invest primarily in bank and corporate debt issuers). However, Prime MMFs have also increased their use of reverse repo given heightened concerns over certain bank risk and would like to continue to do so given that the likelihood that bank deposits could be 'bailed-in' in the future.

3. How do MMFs protect against reverse repo counterparty default?

MMFs use rigorous counterparty selection tools and processes to minimise the risk of the overnight default of the repo counterparty. These operate in parallel to the investment process.

In the unlikely event of overnight counterparty default, the MMF may liquidate the collateral received in a repo transaction directly in the market in order to recover the cash which had been loaned to the defaulting counterparty. Collateral is specifically not intended to be held to maturity unlike the assets which are being held in the investment portfolio. Reverse repo is an overnight transaction and should not be treated in the same way as the investment portfolio.

Typically, the MMF appoints a specialised third party agent to administer the securities received from borrowers as part of reverse repo trades within predefined risk limits (for example, specifying which Government and agency debt is acceptable).

4. How do the EC's proposals prevent the efficient use of repo?

The EC proposal requires MMFs to aggregate

- the risk exposure of the collateral with
- the risk exposure of the securities held within the investment portfolio.

This runs counter to existing best practice standards which separate portfolio management decision making from collateral management. Portfolio diversification and concentration concerns are even less relevant or warranted for Government Liquidity MMFs and Government and agency collateral, given the depth and liquidity of the government securities markets and the small role played by MMFs in those markets.

Best practice aside, the proposal is also impossible to implement: while the MMF's portfolio manager will set out the type of securities that can be provided as collateral, he or she will not know which specific collateral securities have been delivered until it is too late to ensure compliance. Therefore, the MMF's portfolio manager cannot aggregate the unknown reverse repo collateral exposure with securities held within the investment portfolio in order to comply with overall exposure limits.

5. IMMFA recommendations

- IMMFA believes that it is inappropriate to aggregate the risk exposure of the collateral with the risk of the directly owned securities within the investment portfolio and recommends that Article 14(6)(b) be deleted. This limits the aggregate exposure to the same issue of government or agency debt to a maximum of 30% of the assets of a MMF and will be impossible to implement.
- Markets are dynamic; IMMFA therefore believes that ESMA should have the authority to update the repo collateral requirements from time to time to reflect developments in the markets.

Eligible Securitisations – Asset-Backed Commercial Paper (ABCP)

What is ABCP?

Asset-Backed Commercial Paper is the short-term debt issued by a stand-alone entity which uses the funds to purchase assets from various businesses in the real economy. Commercial and consumer receivables (for example, arising from trade, auto loans/leases, equipment loans/leases, and prime residential mortgages) are frequently pooled, sold to this special purpose entity and then used to secure the issue of short-term debt to investors. A manufacturing firm might, for example, sell its trade receivable balances, a car company its auto loans and a telecoms firm its customers' telecoms bills to a special purpose vehicle to fund their business.

During the 2007-2008 financial crisis the phrase ABCP was used too widely – to describe the many vehicles which contribute positively to funding the real economy, but also to describe a range of securitisation structures which were poorly constructed and experienced problems (such as structured investment vehicles (SIVs) and some term mortgage-backed (MBS) and asset-backed (ABS) securities)[4] and which no longer exist. The characteristics which define this valuable ABCP are:

- ABCP conduits are not leveraged and are secured by diversified pools of short maturity, very high quality assets.
- ABCP represents the best quality asset that 'prime' MMFs can invest in and many believe that the ABCP underwriting process, best in class in terms of its credit rigour, should be adopted by other forms of securitization.
- No bank sponsored multi-seller ABCP conduit realized a loss during the financial crisis.
- ABCP conduits were one of the few forms of funding available for companies during the recent financial crisis when the term ABS and RMBS markets were frozen.

Investors appreciate the transparency into and the very high credit quality of the assets held by the ABCP conduit. The bank that sponsors the ABCP program dynamically manages the asset pools with the asset pool seller (such as a car manufacturer) to ensure the pools are of very high quality.

ABCP – a key funding tool for European companies

European companies turn to ABCP to improve their working capital by exchanging receivables for funding which allows them to address their daily needs and expand their business. While large firms such as Telecom Italia, Generali, Renault, Peugeot, Volkswagen, Lafarge, Teva and Enel make use of ABCP, over 50% of asset pool sellers are non rated companies and small and medium-sized companies (SMEs) from across Europe.

EC Money Market Fund Regulation (MMFR) Proposal: Unintended consequences for ABCP

The Commission's MMFR proposal risks reducing a key source of demand for ABCP: MMFs, which represent approximately 50% of all investments in ABCP in Europe. Recital 23 and Article 10 on eligible securitisations rightly acknowledge the important role that ABCP plays in financing economic growth in Europe by increasing the extension of credit to companies and improving their working capital, particularly during distressed cycles. However, the current wording of the EC proposal – unintentionally – will dramatically reduce this key and growing source of funding for European companies as it would substantially limit MMFs ability to invest in ABCP. This outcome would be the result of three requirements in the MMFR proposal:

[4] Structures such as SIVs, SIV-Lites and extendible mortgage backed structured finance vehicles had features (leverage, limited/partial liquidity facilities and market triggers) that meant that, during the financial crisis, these vehicles had to sell underlying assets in the pools to pay investors on maturity dates exacerbating the market distress. They no longer exist.

- That the underlying ABCP exposure be only to corporate debt and not to consumer debt (Art 10a) when over 99% of ABCP conduits contain exposure to both and consumer debt has a better track record than corporate debt in Europe[5].
- That legal / residual maturities be restricted to 397 days when the standard maturities of many types of asset pools (auto loans/leases, corporate / SME loans etc) is five years or less (Art 10c).
- That exposures be limited to 10% or less of the assets of a MMF, which is counterproductive for the economy as it by reduces the ability of MMFs to invest in ABCP, and for MMFs as it hinders the fund's overall diversification (ABCP are composed of highly diversified asset pools) (Art 14.2).

Impact on the 'real economy'

- *ABCP facilitates 'real economy' investment and employment*

ABCP allows companies to free up their capital ('monetize receivables') for capital investment or the hiring of additional employees. The companies typically benefitting from this are SMEs and non-rated firms with limited direct access to capital markets. ABCP has been growing particularly in countries where bank lending is restricted and with companies that have limited or no direct access to capital markets. In addition, ABCP allows banks to finance the loans and receivables of SMEs from a broad range of countries in which they might find difficult to lend to directly. The significance of this role is demonstrated by the fact that some ABCP conduits benefit from supranational guarantees.

- *ABCP facilitates bank lending*

ABCP is a capital efficient way for banks to provide working capital finance to their corporate clients. In addition, by sponsoring ABCP conduits, banks free up liquidity that can be used to loan directly to commercial and consumer clients.

- *ABCP has proven to be useful for governments*

ABCP has proven to be a useful tool in the restructuring and recovery of domestic banking systems; for example Germany created ABCP vehicles to restructure Hypo Real Estate and WestLB and Belgium to restructure Fortis Bank.

IMMFA recommendation

Since the impact of restricting ABCP exposure through the MMFR proposal contradicts the shared public policy objectives of stimulating the real economy, IMMFA suggests the following recommendations:

1. ABCP conduits with both corporate and consumer receivables should qualify as eligible securitisations.
2. The restriction that MMF's aggregate exposure to securitisations should not exceed 10% of its assets should be deleted.
3. The maturity of the asset pools financed in ABCP conduits should be extended to at least 5 years which matches the standard maturities of many types of pools financed in ABCP conduits (auto loans/leases, corporate / SME loans etc).

[5] The European economy and companies benefit both from corporate (for example trade receivables) and consumer receivables (such as retail autos loans and credit card receivables). A July 2013 S&P report on European Structured Finance showed that consumer related securitizations outperformed those backed by corporate loans, with cumulative defaults rates since mid-2007 of just 0.04% compared to 4.68%. The primary defaulting asset classes are ABS CDOs and complex structured corporate credit, in both of which ABCP multi-seller conduits cannot invest.