



IMMFA POSITION PAPERS

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

**The following documents comprise an industry response to the
European Commission's Proposal**

October 2014

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IMMFA Summary Position on Money Market Fund Reform

Money Market Funds

Money Market Funds (MMFs) form a large and important sector of the European mutual fund industry, with just under €1 trillion assets under management. They are used by both retail and institutional investors across many European countries. They are cash management vehicles, which provide investors with access to professional credit and operational risk management skills, in a transparent, low-cost and easy-to-use format.

As well as being a useful tool for investors, MMFs are important for the wider European economy. By aggregating the cash holdings of a wide range of investors, they are able to provide scalable funding for banks, financial institutions, corporations and businesses. They are also the leading investors in the short-term securitised asset market, which has been identified by both the ECB and the Bank of England as a key market to improve the credit flow from the financial sector to the wider economy.

IMMFA

The Institutional Money Market Fund Association (IMMFA) represents MMF managers and sponsors, who offer MMFs to institutional investors. In addition to "short term MMF" regulations and UCITS regulations, all IMMFA members abide by a Code of Practice that sets out the best standards of investment risk management for MMFs. IMMFA works with policy makers to provide information and advice about the European money markets, and to represent the views of MMF managers and investors in discussion about the future regulation. IMMFA welcomes the European Commission's desire to establish more consistent and more transparent regulation of the MMF sector in Europe. IMMFA shares the Commission's aim to ensure that the MMF sector is well prepared for the possibility of distressed financial markets in the future; and to ensure that the MMF sector does not become a conduit through which market contagion passes on to the banking sector.

European Commission Reform Proposals

Nonetheless, IMMFA believes that some of the Commission's draft reform proposals will not achieve these shared aims. If implemented in full, these proposals are likely to make the European money markets less effective while remaining vulnerable to systemic risks. They would make it more expensive for European businesses to raise funds for new investment and more expensive for individuals and institutions to manage their cash holdings.

IMMFA has produced a series of papers which explain in more detail what MMFs are and why they are important to the European economy. They also describe, in some detail, why some of the European Commission's proposals should be amended or withdrawn. These papers make the case for a MMF sector that is safer and more transparent, and which continues to provide services to investors and borrowers in a cost-effective manner.

The Major Risks

MMFs lend money to a range of borrowers, including governments and government agencies, banks, financial and other institutions, and businesses. The main risk to the investors in a MMF is that one of these borrowers fails to repay their loan. A second risk is that market participants judge it unlikely that a borrower will be able to repay, and the price of this borrower's debt falls in value in the secondary market. The best defence against these risks is to diversify the portfolio, with a wide range of high-credit quality assets of short-duration.

Well run MMFs employ a range of risk mitigation strategies and are very unlikely to suffer defaults or significant falls in value. However, if other mutual funds or money market investors encounter

problems with their asset holdings, and sell significant volumes of assets into the secondary markets to liquidate their positions, credit problems can be quickly transmitted to MMFs, a process known as "contagion". Falling prices of bad assets drag down the prices of good assets. In such circumstances, MMF investors might decide to switch from bank and corporate credit to government credit, and a run on MMFs might result.

How to Reduce these Risks

In a distressed market, where prices of both good and bad assets are falling, and where investors embark on a flight to quality, even well run MMFs are vulnerable. Regardless of the amount of liquid assets in the fund, and the credit quality of these assets, when there is a sudden and significant demand from investors to redeem, all MMFs face major challenges. The manager could decide to sell asset holdings to meet redemptions, probably incurring losses and amplifying the rate of falling prices. Or the manager could shut the fund temporarily, imposing a fee on investors who need to redeem, thereby stemming the flow of cash out of the money markets while ensuring that all investors are treated fairly. IMMFA strongly supports this second course of action, namely introducing redemption gates and liquidity fees. These mechanisms make it impossible for investors to run from their MMFs unless they pay a premium for liquidity during a distressed market. These mechanisms are the equivalent for the mutual fund industry of bank holidays in the banking industry. Whereas asset sales by MMFs into falling markets would be likely to accelerate investor flight, the introduction of redemption gates and liquidity fees would help to decelerate the spread of contagion.

Superficial Solutions

A number of other solutions have been proposed to dissuade investors from running from their MMF during distressed market conditions. These include requiring MMFs to hold a capital buffer of 3% of the net asset value of the fund, or requiring MMFs to change their pricing structure - both for the assets in the fund and the fund itself. The European Commission has supported the use of a capital buffer, the move to variable pricing for MMFs and the move to mark-to-market pricing of assets within a MMF. IMMFA believes that these changes would be highly disruptive of the MMF sector, raising costs for investors and borrowers, without reducing the risks that are inherent in the money markets. IMMFA believes that regulatory reforms should focus on the actual causes of risk - the quality of the assets and the ability of investors to redeem their holdings - rather than superficial issues concerning fund structures and prices.

The SEC rule changes

In the US, the Securities and Exchange Commission introduced new rules for US domestic money market funds in July 2014. These rules required some MMFs sold to institutional investors to convert from constant to variable pricing. There are several exemptions to this rule, which means that around 75% of US domestic MMFs will remain constant net asset value funds. In addition the SEC determined that all MMFs would be permitted to introduce redemption gates and liquidity fees. However, the SEC rejected the idea of capital buffers for money market funds, which it considered to be costly and ineffective.

Conclusion

There is no evidence to suggest that changes to accounting and pricing structures within MMF would stop investors from running when markets become distressed. By contrast, imposing redemption gates and liquidity fees would be a cheap and effective solution. IMMFA supports the introduction of smart regulatory reform, which will preserve the benefits of the MMF sector - for investors and borrowers - while reducing systemic risk.

1) IMMFA Fact Sheet on Money Market Funds

Money Market Funds

Money Market Funds (MMFs) are collective investment schemes. MMFs in Europe are governed by guidelines issued by the European Securities Markets Authority (ESMA). There are two sets of guidelines, one set for 'Money Market Funds' and another, more restrictive set for 'Short Term Money Market Funds'.

The MMFs represented by IMMFA are all UCITS funds and Short Term Money Market Funds. In addition, IMMFA MMFs adhere to a Code of Practice which is more restrictive than the ESMA guidelines and which represents industry best practice for low-risk, highly liquid, conservatively-managed MMF which are 'cash equivalent'. The primary objectives of IMMFA MMFs are the preservation of capital and the provision of liquidity. They also aim to provide investment returns in line with money market yields.

MMFs have management boards, which owe a fiduciary duty of care to their investors. Boards are responsible for ensuring that credit and risk management, portfolio construction and stress testing are effective. Boards also have a duty to ensure that all shareholders are treated fairly.

Why investors use MMFs

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

Government deposit insurance schemes apply only to the first €100,000 of a depositor's funds held at a bank. Institutional investors, such as corporations, charities and public institutions, therefore have to be very aware of the credit and operational risks to which their short-term cash is exposed.

To mitigate these risks MMF managers spread their investments across a wide range of different counterparties to avoid over-exposure to a single entity. If the risk is spread widely then, in the highly unlikely event of a default by one of these counterparties, the impact of any loss is reduced.

MMF managers monitor the quality of all the counterparties with whom they invest, making use of the credit rating agencies without becoming wholly reliant upon them. They also make the various bank transfers required every day to effect payments, which would be operationally risky and administratively onerous for institutional investors to make for themselves.

By using MMFs, investors are able to resist the tendency to deposit their cash with the larger, familiar, "too big to fail" banks. Moreover, when an investor deposits money with a bank they are exposed to the wide spread of risks represented by all the different assets owned by the bank, many of which they will know nothing about.

By contrast, investors appreciate the transparency provided by MMFs, which report regularly to investors on many different aspects of the fund, including full disclosure of all the assets it owns. These assets are held in third party custody accounts, which protects investors from any potential financial problems at the manager, distributor and custodian. In the event of a problem at one of these service providers, the assets are protected for the sole benefit of the investors in the fund.

Why borrowers value MMFs

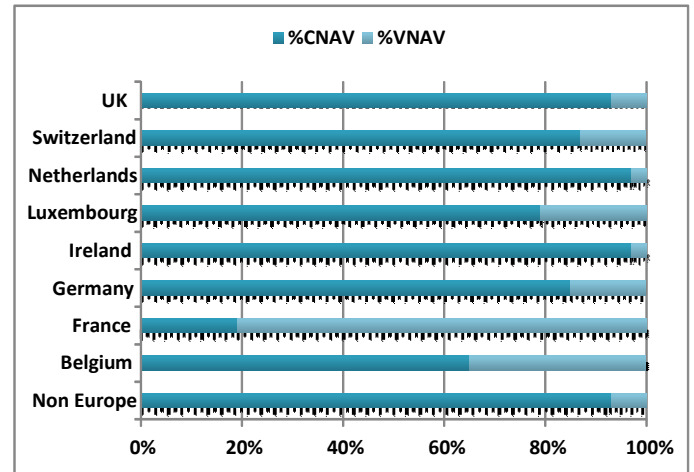
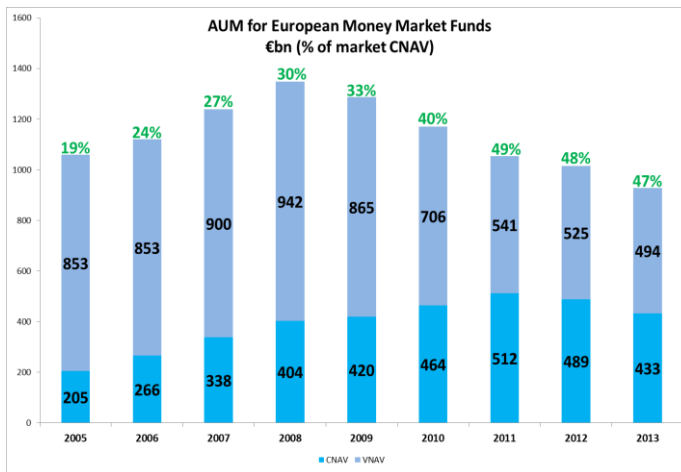
The short-term debt markets are an important component of the overall capital markets in Europe. They allow a wide range of banks, corporate treasuries, government entities and agencies access to flexible and

competitively priced funding. The European Commission has the stated aim of increasing the volume of funding by the capital markets in Europe.

MMFs are significant investors in the European short-term debt markets. Ill-considered regulation of MMFs might reduce activity in the European short term capital markets, making it harder and more expensive for borrowers to access capital.

€1 trillion assets under management

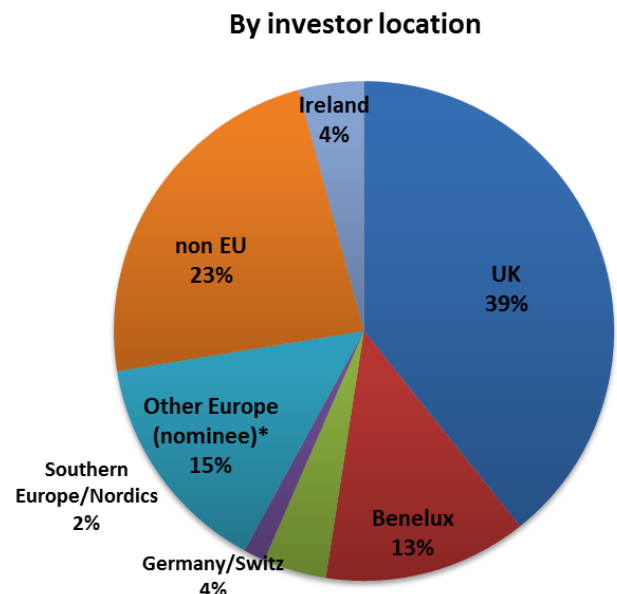
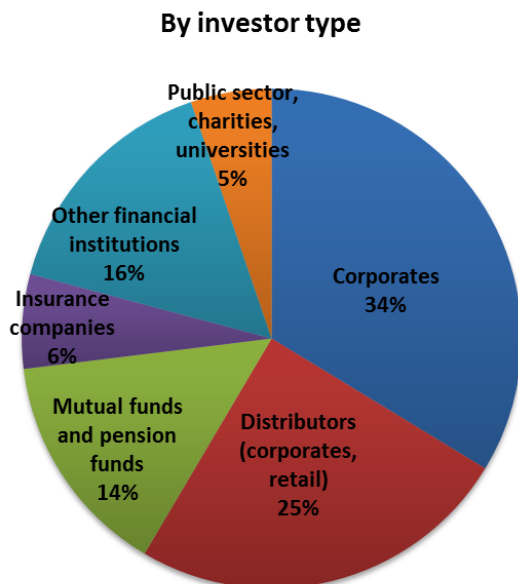
With almost €1 trillion under management, MMFs are an important sector of the asset management business in Europe. Roughly half of these assets are held in Constant Net Asset Value (CNAV) MMFs, which are represented by IMMFA. The other half are held in Variable Net Asset Value (VNAV) MMFs. The charts below show the relative proportions of CNAV and VNAV MMFs in various European countries. They also provide details of the investors, by location and investor type.



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

Investors in CNAV MMF at end Dec 2012

Source: IMMFA



How does a CNAV MMF work?

The net asset value of a share of a fund is the value of all the assets added together (once any liabilities have been netted off), divided by the number of shares outstanding. CNAV funds are managed in such a way that their price, when expressed to 2 decimal places, remains at 1.00 (in normal circumstances). The interest which is collected each day on every security in the fund is calculated and then distributed in the form of additional fund units. This is the yield earned by investors in the fund for that day.

CNAV MMFs make use of amortised cost accounting. When an asset is purchased, both the purchase price and the redemption value are known from the outset. "Amortised cost" assumes that the increase in value from when a security is issued to when it is redeemed is added in equal increments each day. In other words, the progress from purchase price to redemption price takes the form of a "straight line".

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).

Using constant net asset values and amortised cost accounting are both appropriate for MMFs owing to the types of instrument that the funds buy and the fact that they are very low risk. These instruments include commercial paper, certificates of deposit, short-term government debt, investments in overnight deposits, call accounts and reverse repo. All of these assets are characterized by minimal volatility in price. The likelihood of large variations in price of short-duration, high-quality assets in the time scale is extremely low. In addition, more than 99% of investments made by short-term MMF are held to maturity.

Why investors prefer CNAV Funds

Some investors require CNAV MMFs, while others prefer them, for a range of reasons, including:

- CNAV funds are able to offer same-day settlement, meaning a fund can pay an investor back on the day they ask for money. This is essential for institutional investors who use MMFs for their day-to-day cash management activity, e.g. to make payroll payments, to cover tax and pension payments.
- The investors are averse to variation of the capital value of their short-term cash.
- Institutional clients often use MMFs as a cash management tool in which to 'sweep' operational balances. This is very straight-forward operational process when all transactions are valued at 1.00.
- In many countries, corporate treasurers prefer their daily yield in the form of interest income rather than capital gains.
- CNAV MMFs allow for easy tax and accounting reporting, which is important for institutional investors.

2) The Economic Importance of Money Market Funds

The European Commission's proposal for the regulation of Money Market Funds (MMFs) would, if enacted in its current form, lead to the elimination of Constant Net Asset Value (CNAV) MMFs from Europe. There are a number of predictable consequences of such an outcome, all of which would have a negative impact for the European economy.

Many institutional investors will switch their cash from MMFs to “national champion” banks

The majority of institutional investors make use of CNAV MMFs in order to have access to professional credit analysis. If CNAV MMFs ceased to exist, these investors would not be able to afford the cost of building their own teams of credit analysts. Most of them do not have the size of assets to justify a segregated mandate with an asset manager. Without access to professional credit analysis the majority of investors will opt to deposit their cash with a small number of large, relationship banks that they believe are “too big to fail”, namely the “national champion” banks.

Lower returns will reduce investment in the European economy

There is currently >€500 billion invested in CNAV MMFs, and if most of this cash was switched to “national champion” banks it is likely to be concentrated among a small number of large banks, many of which do not need short dated funding. These banks are likely to lower the interest rates they pay to depositors. If, over time, the average reduction was 1% per annum, this would lower income of corporate treasuries and charities in Europe by close to €5bn per annum. The impact of this loss of interest income is like to be passed on to the European consumer through higher prices of goods and services but, more importantly it will lead to a reduction in the capital available for investment in the economy.

The economic benefits of securitisation

Reviving the securitisation market is a key policy objective of the ECB and the Bank of England because of its role in directing low-cost, wholesale funding to the wider European economy. A key part of the securitisation market is the short-dated market in commercial paper, known as Asset Backed Commercial Paper (ABCP).

The ABCP market in Europe has shrunk significantly since 2007 when it reached over US\$ 500bn in issuance. If the ECB and the Bank of England are to achieve their objective of a recovery in issuance of securitisation in Europe to help support credit growth in the region it will require a vibrant ABCP market which it is not achievable without CNAV MMFs. This is because CNAV MMFs own approximately 70% of outstanding ABCP in Europe (as at June 2014).

“National champion” banks will reduce lending to the wider economy

Many large banks are being offered more short term funding than they require, but they continue to accept wholesale deposits from key clients, for relationship purposes. The banks appreciate that it is valuable for their corporate clients to have the ability to deposit short-term cash with a low risk counterparty. Changes to bank regulation, with regard to capital and liquidity requirements, have disproportionately penalised banks for accepting short-term wholesale deposits. These changes in regulation have been designed to make the banking sector more robust, but they mean that when banks provide a valuable service to their corporate clients they are also reducing their ability to lend to other customers, because more of their capital is tied up.

Reduction in investor choice

Institutional investors still require liquidity to run their day-to-day operations, but their investment options will be reduced. This phenomenon increases investment risk as their credit risk exposures become more concentrated.

French banks will likely be hit hardest

French banks are the biggest beneficiaries of funding from CNAV MMFs yet very few of the underlying investors are French. If CNAV MMFs reduce in scale significantly, owing to the EC reform proposals, French banks will most likely lose this funding, because the institutional investors are more likely to switch their funds to national banks, rather than making cross-border deposits.

Any reduction of wholesale market funding to the banking sector is likely to lead to an increase in the number of banks reliant on central bank and funding, which will also increase the cost of lending in the wider economy.

3) Redemption Gates and Liquidity Fees

The main objective of better regulation of Money Market Funds (MMFs) is to prevent large scale runs from funds, which would likely amplify the risks to the banking system at a time of systemic disruption.

The simplest and most effective mechanism by which to achieve this objective is to limit the ability of investors to withdraw cash from MMFs. This mechanism - called a redemption gate - should be used at times when MMFs have insufficient liquidity to meet investor redemptions requests in a way that would be equitable to all of the investors in the fund.

The European Commission's proposal that MMFs should be forced to build capital buffers would be much less effective because these buffers do not impact directly on the flow of liquidity out of MMFs.

Normal liquidity management

MMFs manage daily investor redemptions from their reserves of liquidity. Portfolios are constructed to have a regular series of maturities over the coming days and weeks to ensure that liquidity reserves are regularly supplemented. If larger than normal redemption requests are received it is possible to generate additional liquidity through asset sales. However, the sale of assets by MMFs is comparatively unusual, with 99% of investments being held to maturity.

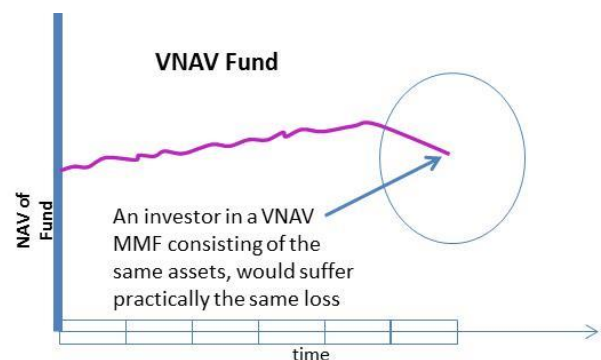
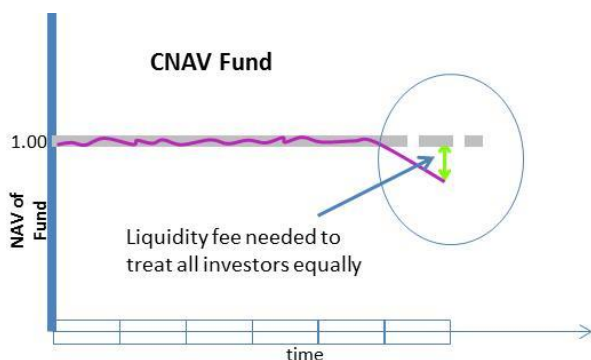
Stressed markets

If concerns about falling asset prices become widespread across the economy and, as a result, there is increased risk to the banking system, then MMFs need an effective way to prevent the risk of investor flight. In 2008 there was no consensus as to the best mechanism to deal with investor redemption requests in a stressed market. As a result, many MMFs sold assets to create added liquidity, leading to a downward spiral in the prices of short-term assets.

Regulatory reforms that will work

IMMFA has developed proposals to pass the cost of asset sales in distressed markets to those investors who seek to redeem from their MMF. These proposals have a number of advantages:

- They impact directly on the level of liquidity in the Fund.
- They are triggered by objective criteria, which are observable to investors and regulators.
- They are equitable to all MMF investors, and therefore consistent with the fiduciary duty of the investment manager and the board.
- They provide investors with an incentive not to run from the fund. But they do allow investors who require liquidity urgently to withdraw cash, at a price that is fair to all investors.



IMMFA recommendations

Redemption gates and liquidity fees are the best mechanisms by which a MMF manager can control redemptions in times of market stress. They will prevent runs on MMFs that might amplify levels of systemic risk in the capital markets.

Investors are able to access their cash, but must pay a liquidity fee if they do so. This ensures that those investors who remain invested in the fund are no worse off as a result of the actions of the those investors who redeem from the fund.

A well-designed liquidity fee will act as a decelerant of investor redemptions because most investors will not want to incur the costs imposed. The liquidity fee creates a last-mover rather than a first-mover advantage, ensuring that those investors who remain invested in a MMF are protected from the impact of investors who redeem during a period of stress.

IMMFA's proposals can be summarised as follows:

- **Trigger based** – Under the EC's regulatory proposals, Short-Term MMFs must hold a minimum of 20% of their assets in liquidity assets of one week maturity or shorter. IMMFA proposes that the redemption gate would be triggered if the one week liquidity level falls below 10% of the assets under management (i.e. half of the normal regulatory requirement). Basing the trigger on the one week liquidity level ties the mechanism directly to the “run” risk that policy makers are seeking to address. Setting the trigger level at 10% reduces the probability of the redemption gate being applied unnecessarily.
- **Mandatory implementation** – Making it a mandatory requirement to apply a liquidity fee and redemption gate if the trigger is passed, removes any subjectivity. This will provide clarity to investors and reassurance to policy makers that these measures will be implemented. A mandatory implementation of a trigger based liquidity fee and redemption gate would not prevent the board of the MMF from applying a liquidity fee and redemption gate prior to the trigger being met, if this was in the best interest of the investors in the MMF.
- **Floating fee** – The liquidity fee should reflect the estimated cost of raising liquidity to meet redemptions. Consistent with treating shareholders fairly, it should be based on the estimated cost to the MMF as a whole, and not merely the cost of selling the most liquid assets in the portfolio. Calculated this way the fee is fair to all and punitive to no-one.
- **Cure terms** – To ensure the liquidity fee and redemption gate mechanism is transparent for investors and regulators, IMMFA recommends that:
 - The liquidity fee may be lifted once the one week liquidity level has returned to 20%
 - The redemption gate must be lifted within 10 business days
 - Once one week liquidity levels have reached 20% in the period after the implementation of a liquidity fee, the MMF manager may choose to maintain a liquidity fee if it believes this to be in the best interest of all shareholders.

Liquidity fees and first mover advantage

The purpose of introducing a liquidity fee and a redemption gate is to ensure that those investors who redeem do not get better treatment than those investors who remain. In short, liquidity fees and redemption gates remove the “first mover advantage”. Those who decide to redeem pay a fee equivalent to the estimated cost of raising liquidity: this loss, once realised, will not be refunded. Since asset prices generally recover to normal levels, once price volatility subsides, it is likely that those investors who remain in the fund will not realise any losses when they redeem at a later date. These investors will end up better off, enjoying a “last mover advantage”.

4) Why Capital Buffers Won't Work

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 capital buffer, of 3% of the net asset value of the fund, within three years. The aim of the capital buffer is to provide assurance to investors that if the MMF manager is forced to sell assets in a falling market, this will not impact on the value of the holdings of investors, thereby taking away any incentive to "run" from the fund.

IMMFA members have serious concerns about the likely impact of this proposal on investors, the European economy and the MMF industry. IMMFA believes that redemption gates and liquidity fees are a more appropriate mechanism to achieve this policy objective.

The investor's perspective:

Investors typically redeem because they have concern about the quality of the assets which the MMF is holding. In a systemic crisis, investors do not know the potential scale of losses that the MMF might suffer and are unable to judge whether or not they will amount to 3% or more. Investors might decide that they want to reduce their exposure to the credit markets if they switch their money elsewhere, for example, into government securities. This behaviour is likely to occur irrespective of whether the investor's cash is held in CNAV or VNAV MMF, short-term debt, reverse repo or even a bank deposit. In a stressed market, investors fly to quality, and the existence of capital buffer would make no difference.

Even if the capital buffer were 10% or more, investors are still likely to prefer holding government-guaranteed securities rather than having a 10% exposure to the sponsor of the MMF, which itself may be a bank. Even if the capital buffer were held as cash in a segregated account, the investor is still exposed to the credit risk of the institution where the buffer has been deposited.

The fund manager's perspective:

The size of the capital buffer required to be effective in a systemic crisis would be totally uneconomic for the sponsor of a MMF. This is the conclusion that the SEC came to in its June 2013 report, which stated that capital buffers might be helpful in times of modest market stress but not in a systemic crisis. In September 2008 the Reserve Fund in the US suffered a major run following the collapse of Lehman Brothers, although ultimately the loss on this fund was around 1%. In contrast to the USA, European governments and central banks intervened in 2008 to support large numbers of banks that were in serious financial difficulty. Most investors did not run because they believed - correctly - that EU policy makers would not allow a major bank to fail. Had a major European bank failed, the potential losses to MMF investors in Europe would have been substantial, potentially far higher than the proposed 3% capital buffer.

The academic perspective:

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 a systematic banking crisis are access to central bank liquidity or the suspension of convertibility, commonly known as 'bank holidays'.

The same is true for MMFs. Capital reserves will almost certainly be insufficient to protect MMFs from runs if 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, because they are investment products not banking products. They are, however, able to suspend convertibility, by introducing redemption gates, which are

the equivalent of bank holidays in the securities market. The prospectuses of most MMFs already provide for such measures. Investors choose to use MMFs because their investment risk is diversified across the many different assets in the portfolio. If the fund manager is obliged to take the first 3% loss, the investor would be exposed to the credit risk of the fund manager, which would change the risk profile of the MMF.

Impact on the European economy

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

The current assets under management of CNAV MMFs are around €480 billion. Applying the proposed 3% buffer would require a total of around €14 billion of capital to be set aside. Of this, €4 billion would be provided by non-bank sponsors, but the balance of €10 billion would come from bank sponsors.

Banks are constrained by the amount of capital they have available. If they were obliged to allocate €10 billion to provide buffers for MMFs, that amount would have to be withdrawn from the wider economy. This effect would be amplified, as banks are geared typically between 20 to 25 times, resulting in a reduction of lending to the European economy of €200 to €250 billion.

A capital buffer would eliminate CNAV funds

Fund managers, like any other business managers, need to earn a reasonable return on their capital in order to remain in business. For asset managers, the expected level of return would be at least 10%. In order to earn 10% on a newly introduced 3% capital buffer, the fund would have to generate an additional return, net of all other expenses, of 0.3% or 30 basis points. Currently, the net fees earned by a MMF are typically 8-10 basis points and it seems very unlikely that investors would be willing to accept fees rising from 10bp to 40bp, to cover the addition 30bp that the capital buffer demands.

The 3% capital buffer might lead to the MMF provider being deemed to have a 3% economic interest in the MMF. If so, the manager will have to consolidate the MMF onto their balance sheet and subject it to regulatory treatment. This would require up to 8% of the assets under management in the MMF to be injected in the form of Core Tier 1 (CT1) capital.

Thus, the actual amount of capital implied by the buffer would be 3% at a minimum but could rise to over 8%. These levels of capital would be completely unaffordable, given the business economics of MMFs. Further, capital placed in a 'Reserve Account' with a credit institution might 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.

Capital buffers do not address systemic concerns

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 risk profile nor any greater susceptibility to runs in one type of fund or the other.

The introduction of capital buffers would lead to the conversion of any CNAV MMFs to VNAV. However, this conversion will not prevent client redemptions in times of market stress, therefore systemic risk will not have been reduced. The presumption that VNAV investors would be more content to take losses than CNAV investors is completely implausible, and there is no evidence to support it.

5) The Use of Amortised Cost Accounting

Article 26 of the European Commission's proposed Regulation recommends that, where possible, assets should be valued by marking them to market. IMMFA recommends that MMFs managers be permitted to continue to use amortised cost accounting for the majority of assets in MMFs.

Problems with mark-to-market

Money market funds (MMFs) are portfolios of money market and fixed income instruments – such as commercial paper, certificates of deposit, short-term government debt, overnight deposits, call accounts and reverse repo - all of which have short maturities. Of these, 99% are held to maturity after their initial purchase.

This is true for the majority of investors in the short-term debt markets, not just MMF managers. Consequently, the amount of paper traded on the secondary market, i.e. assets sold and bought again after their initial issuance, is a small fraction of the amount of primary issuance. This means that often there is no easily recorded price or quote for a money market securities, in sharp contrast to the published prices for equities and fixed income instruments.

The main fund administrators have confirmed to IMMFA that they are not able to source estimations of value on this basis for MMF assets in the way that they are able to, for example, for funds investing in exchange traded equities. However, MMFs closely monitor their ability to be able to sell 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.

Owing to the limitations of mark-to-market in the money markets, 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 pricing

A mark-to-model valuation is an estimate based on a view of current market conditions, and these are commonly employed by IMMFA fund managers to provide their price check for their shadow NAVs. Commercially available independent pricing-models take account of the market conditions at the time of valuation, but all these models involve a certain amount of subjectivity.

It is impossible for third party pricing models to provide totally accurate market valuations for the money market assets held by MMFs. It is only possible for them to estimate the market value of the assets, by using indications of trading prices from market dealers. The subjectivity inherent in these models becomes much 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. Amortised cost accounting assumes that the value moves in a straight line from the purchase price to the redemption value, that the change in value is added in equal increments each day. This is an accurate approximation when used for very short maturity and high quality money market assets. There is no subjectivity involved in this method of estimating asset values.

One feature of MMFs that is highly valued by investors is the fact that funds can be redeemed for same day value, or T+0. Amortised cost accounting gives short-term predictability to the value of the fund. Prices change in equal increments, so the fund administrator knows how the value of each asset will vary from one day to the next.

If a VNAV MMF uses true mark-to-market or mark-to-model pricing, the fund administrator cannot know the value at which they will be able to redeem shares, until trading has ceased for the day.

Some VNAV MMFs aim to address this problem by having a NAV based on “stale” pricing – prices established the day before – but this process would be impossible to employ in a stressed market. To date the majority of VNAV have used amortised cost accounting to give additional certainty to the determination of the value of the fund.

Accounting standards

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 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).

IMMFA 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 - known as the "shadow NAV" - not diverging from the amortised cost valuation by more than 0.5%.

6) How to Define Liquidity Requirements

In a Money Market Fund (MMF) liquidity represents the ability of the manager to convert assets into cash at short notice, to meet the redemption requests of investors. This is one of the most important mechanisms by which MMFs are able to withstand unexpectedly high levels of redemptions and, consequently, allows them to continue to operate during periods of market stress.

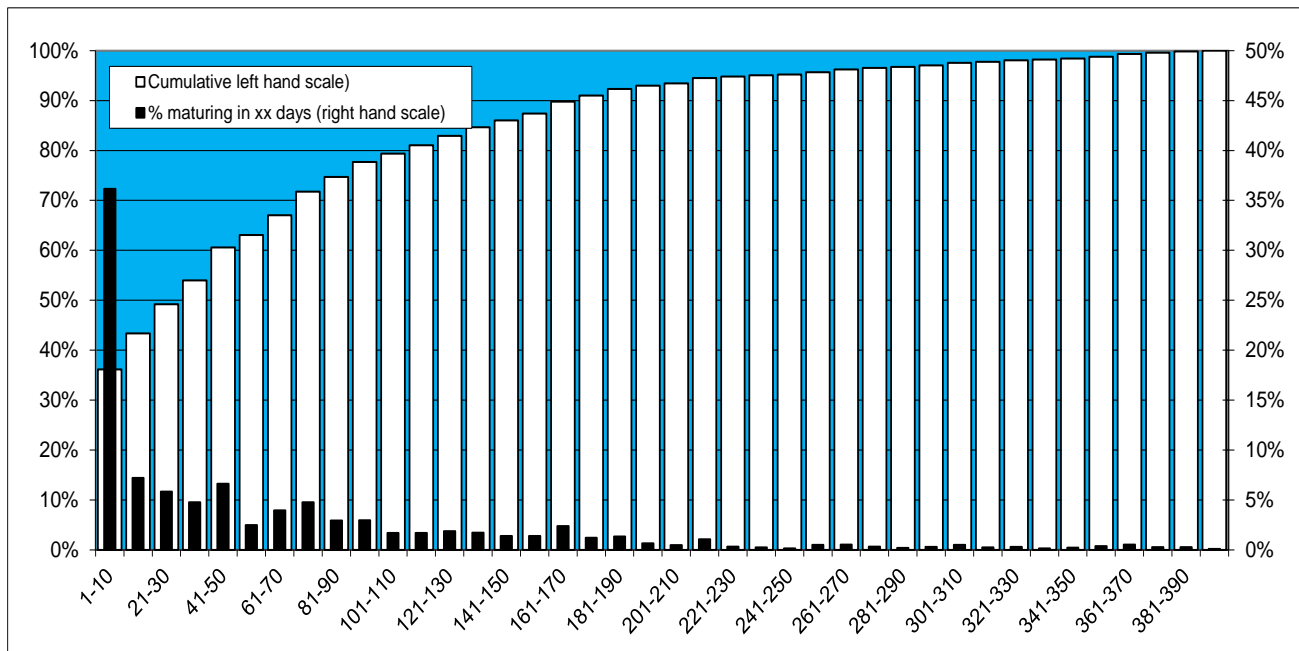
The European Commission has proposed minimum liquidity requirements to ensure that all MMFs are able to do this. IMMFA supports this proposal. However, if the liquidity requirements are inappropriately calibrated they might have some unintended and undesirable impacts, so some small changes to the proposed regime are needed to ensure it works effectively.

How MMFs manage liquidity

MMFs manage liquidity by:

- Holding investments that mature on the next day, and on the next few days
- Establishing a pattern of maturities in the portfolio such that there are regular maturities
- Holding some extremely liquid assets in the portfolio – such as government debt - which can be sold into the market to generate additional cash, in the event this becomes necessary

Maturity profile of IMMFA MMF



Source: IMMFA, April 2013

The European Commission proposal

The EC has proposed that at least 10% of a MMFs assets must mature on the next day and that at least 20% must mature within the next week. IMMFA supports these liquidity levels, which are identical to those in the IMMFA Code of Practice. All IMMFA MMFs already meet these liquidity requirements.

The EC also proposes that the weighted average maturity (WAM) should be not more than 60 days for a Short-Term MMF and 180 days for a MMF; and that the weighted average life (WAL) should be no more than 120 days for a Short-Term MMF and 365 days for a MMF. These are indicators of the duration of the fund. Again, these requirements for Short-Term MMFs are identical to those set out in the IMMFA Code of Practice, so all IMMFA funds already meet these duration requirements.

What changes need to be made?

Highly liquid securities, such as government and government agency securities, which can be bought and sold at short notice, should be included in the relevant short-term maturity calculation. For example, if an instrument can be sold for same day value – e.g. a German Bubill – it should be included in the “daily maturing assets”. If it can be sold for settlement on a T+2 basis (the fund receives the proceeds of the sale 2 days later), it should be included in the “weekly maturing assets”.

Some types of debt securities, such as those issued by governments, sovereign or supra-sovereign agencies, are generally easy to buy and sell. It makes sense 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 sold at short notice to generate cash. The IMMFA Code of Practice already includes them in the liquidity calculation.

The EC should clarify that for debt securities where the investor can choose the date upon which repayment is made, the “maturity date” should be the earliest date upon which redemption can occur. These are known as a “puttable” securities.

In a standard debt security, the issuer and the investor agree in advance when the security will mature, and on this date the issuer repays the investor. However, some securities are designed in such a way that the investor can decide (within a given range) when the repayment will be made. This creates flexibility for the investor.

IMMFA believes that the maturity date for inclusion in the categories of “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. This is currently the standard treatment according to ESMA guidelines.

7) Fund Level Ratings

Institutional investors, such as corporations, pension funds, local authorities and charities, do not benefit from government deposit guarantees and are, therefore, very sensitive to credit and liquidity risks to their cash holdings. Institutions do not typically have in-house credit expertise and rely upon the opinions of the credit rating agencies (CRAs) when reviewing money market fund (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. The CRAs provide a level of independent monitoring and analysis that investors are often unable to perform.

MMF fund ratings

The CRA require that MMFs meet stringent credit, liquidity, diversification, governance and other requirements in order to secure the triple-A rating. The CRA then monitors adherence to these requirements on a daily, weekly and monthly basis; in addition it carries out an in-depth formal review of the MMF on an annual basis to determine whether the MMF deserves to retain its triple-A rating.

The popularity of MMF ratings in Europe

Usage of MMFs spread rapidly in Europe following the failure of Barings Bank in 1995, when many investors were temporarily faced with the possibility of losing their deposits and unsecured investments. Institutional investors were attracted by the opportunity to place their cash in a diversified portfolio, held in a regulated, mutual fund structure, using third party custodians. This allowed them to reduce their risk exposure to individual banks.

Today, the investment guidelines of most institutional investors – which are approved by the boards of corporations, and by the trustees of pension funds and charities - require that any MMFs they invest in should have a triple-A rating from at least one and often two CRAs.

By contrast, in the US many of the criteria used by CRAs in their ratings process have been included for decades in Rule 2a-7 of the Investment Company Act (1940) which regulates MMFs in the USA. Institutional investors were less demanding of credit ratings because they were already protected by the Rule 2a-7 requirements. This explains why over 98% of CNAV MMFs in Europe are rated by the CRAs, compared to only 60% in the USA.

The European Commission proposals

The EC is proposing that MMFs 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). The stated objective of the proposed prohibition on fund level ratings is to avoid the situation where a downgrade of the rating of a single MMF causes an investor run on all MMFs.

However, it is important to note that when the PrimeRate MMF was placed on Rating Watch Negative by Fitch (on 7th Dec 2011), leading to the redemption of 50% of its assets within a week, there was no contagion among other funds.

Implications for MMF clients

The prohibition of fund level ratings, coupled with MMF providers being prohibited from referencing CRA ratings in managing the MMF, will almost certainly create a number of difficulties for institutional investors. They will no longer have access to an independent, professional advisor to help them judge the quality of

the MMF manager. Over time this is likely to lead to less consistency and less comparability across the MMF sector. Based on discussions with investors, IMMFA believes that if ratings are prohibited a significant proportion of clients will cease investing in MMFs, either because their investment guidelines prohibit investment in unrated MMFs or because they feel uncomfortable investing without the benefit of an independent credit risk opinion.

Implications for systemic risk

IMMFA believes that concerns over the impact of MMF downgrades on systemic risk are misplaced:

- MMF rating downgrades are very rare. When they have occurred they have been related to the specific circumstances of individual firms and have had no systemic impact. The investors in a downgraded MMF simply switch their cash to other MMFs. As happened in the case of PrimeRate, there is no contagion to other funds.
- There is a risk that investors will switch out of unrated MMFs and into rated bank debt. As a result, “national champion” banks will receive greater inflows of volatile, short-term institutional deposits, which is contrary to the intent of CRD IV to create a more stable, retail, long term deposit funding base for banks.
- The amount of assets managed by MMFs will shrink significantly, working against the desire of policymakers to create greater balance between bank finance and capital market finance in Europe.

IMMFA recommendation

Many institutional investors draw a degree of confidence from the ratings process, which they regard as a beneficial supplement to and an independent verification of the requirements of the regulatory regime in Europe. It is important to retain investor confidence in the European money markets, and the CRAs remain an essential part of the investment process for many investors.

8) The Credit Process and the Internal Rating Scale

The European Commission's proposal

The European Commission (EC) wants to avoid investors in money market funds (MMF) adopting a mechanistic reliance on credit rating agency ("CRA") ratings. It is also concerned that, where funds are rated, if a CRA downgrades a security, all MMF managers who hold the security would be forced sellers, causing problems for that issuer and potentially for the wider financial system (known as "cliff risk").

To avoid this, the EC proposed that external CRA ratings should not be referenced by MMF managers in their investment process. Instead, the EC recommends a standard internal rating scale for all MMFs. 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.

Current practice in MMFs

The ESMA guidelines and CRA requirements together define the broad universe of eligible securities, specifying the minimum credit rating for individual securities allowed in a MMF portfolio. For example, ESMA requires that Short Term MMF only invest in securities that hold one of the two highest available short-term credit ratings.

These requirements represent the starting point for MMF managers. Each MMF manager has one or more credit analysts, whose job it is to undertake detailed reviews of the wide universe of issuers and securities in order to identify those issuers suitable for the "Approved List". MMF portfolio managers can only invest in the issuers on the approved list, at the maturities specified. Best practice requires that those responsible for selecting and monitoring issuers and securities for the approved list be in a separate team from the portfolio managers who construct the MMF.

These credit reviews are far from mechanistic. Rather they form an essential part of the core proposition to MMF investors, because the credit review determines the quality and liquidity of the MMF, reducing risk for investors. For most MMF managers it is qualitative factors (such as an assessment of a issuer's competitive position, its management quality and its downside risks) that preponderant in the process.

The effectiveness of internal credit processes is demonstrated by the fact that issuers are almost invariably removed from MMF Approved Lists well before they are downgraded by CRAs.

Problems with the European Commission proposal

IMMFA agrees with the European Commission that the credit analysis carried out by MMF managers must not be mechanistic. However, the internal rating scale proposed by the EC is not appropriate for MMFs, and runs counter to best practice in the management of MMFs:

- The rating scale proposed for MMF has been based on that required by prudential regulators of banks. This rating scale places different types of loan (retail mortgages, unsecured retail loans, corporate loans, from SMEs to "national champions", infrastructure debt etc.) into six different categories of risk, with an additional category for defaulted assets.
- Compared with bank loan books, MMF portfolios are much more homogeneous. The differences between the eligible assets permitted for MMF are marginal. The "six + one" bank loan rating system is overly-complicated and inappropriate for MMFs.

- The EC proposals also run counter to sound liquidity management in MMFs. It reflects a bank credit approach, whereby banks take a long-term credit view, focused on the solvency of the entity and based on an analysis of relative probabilities of default. By contrast, the MMF approach is anchored in a short-term view of an entity's liquidity (not solvency), on the possibility of a downgrade (not default) and is binary (not relative).
- The ability of a MMF to meet client redemption requests depends on the liquidity rather than the solvency of the issuer. The probability of default of investment grade commercial paper or time deposits within a MMF investment horizon is minimal. Data from Moody's shows that on average, between 1983 and 2012, only 0.25% of short-term commercial paper rated P1 at the beginning of the year had been downgraded below investment grade by the end of the year.
- The question that MMF credit analysts ask, therefore, is: Do we think this issuer is likely to be downgraded below A1/P1 within the next 12 months? If the answer is yes, then this issuer will not be included on the Approved List.

Implications of the European Commission proposal for investors

Judgment forms the basis of good credit analysis. IMMFA fears that the EC proposal will increase the focus of MMF managers on the classification of issuers, to the detriment of qualitative risk analysis. An unintended consequence of the EC's proposals would be to make credit analysis in MMFs more mechanistic.

Eliminating CRA ratings will lead to less consistency and comparability across MMFs. MMFs will be able to invest in a broader universe of securities than today, leading to more disparate outcomes for investors, especially given the larger number of MMF managers than CRAs. There is little comparability across bank loan portfolios despite the fact that the rating scale now proposed for MMFs has been in place for banks for decades.

The CRAs are in receipt of material non-public information about issuers, such as their future financing plans, to which MMF managers quite rightly are not privy. Including reference to their ratings in the credit policy of the MMF is thus of benefit to investors, since it improves the risk management of the MMF.

IMMFA recommendation

IMMFA agrees that MMF managers must carry out their own internal credit analysis and that this must not be mechanistic. We recommend that the EC proposals be amended to align them better with those of IORPs, UCITS and AIFs. These require the manager of a MMF to employ a risk management process which enables it to monitor and measure at all times the risk profile of their positions and their contribution to the overall risk profile of the MMF. MMFs do not and should not rely mechanistically on credit ratings issues by CRAs.

9) Reverse Repurchase Agreements

Summary

Money market funds (MMFs) use reverse repurchase agreements (reverse repo) as a secure means of investing cash from the portfolio, receiving high quality collateral in return and thereby reducing their unsecured bank risk exposure. The vast majority of reverse repos are overnight transactions, that is, the exposure of the MMF to the counterparty is also overnight and the risk of default is minimal. MMFs use rigorous collateral management processes, typically provided by specialised third party agents, to reduce further credit and operational risk.

The European Commission has proposed that MMFs aggregate the risk exposure of the collateral with that of the securities held within the investment portfolio. This would be operationally impossible to implement and would effectively mean that MMFs would no longer be able to use reverse repo for managing liquidity. Collateralised lending (reverse repo) should be preferred over unsecured deposits (bank deposits) in regulation because it lowers the risk of loss for investors.

Reverse repo in MMFs

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 start of the trade, thereby producing the rate of interest which will be paid for the loan of the cash.

MMFs lend out cash to high quality counterparties, usually on an overnight basis in exchange for high quality collateral, such as government and agency securities. This helps to reduce the MMF's exposure to bank credit.

Government Liquidity MMFs do not permit exposure to bank deposits. As government bonds do not mature every day but on 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 be forced to sell investments in government bonds to meet investor redemptions.

Reverse repo performs the same function - providing daily liquidity - for Government MMFs as overnight bank deposits do for Prime MMFs, which invest principally in bank and corporate issuers. However, Prime MMFs also make use of reverse repo, given the decline in the number and credit quality of the major banks in recent years, and would like to continue to do so.

Default risk

MMFs use rigorous counterparty selection processes to minimise the risk of the overnight default of the repo counterparty. These operate in parallel to the investment process. Typically, the MMF appoints a specialised third party agent to administer the collateral received from counterparties as part of reverse repo trades, all of which must conform to predefined risk limits.

In the unlikely event of a counterparty default, the MMF would be entitled to liquidate the collateral received in the repo transaction in order to recover the cash which had been loaned to the counterparty. Collateral is not intended to be held to maturity, unlike the assets in the MMF. Reverse repo is almost always an overnight transaction and the collateral received in the transaction should not be treated in the same way as the other assets in the MMF.

The European Commission's proposals

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, which separates portfolio management decision making from collateral management.

In particular, these proposals are irrelevant for Government Liquidity MMFs, given the depth and liquidity of the government securities markets and the small role played by MMFs in those markets.

The EC proposal would be impossible to implement: while the MMF's portfolio manager will define the type of securities that can be provided as collateral, they will not know which specific securities have been delivered as collateral until close of business, when it is too late to ensure compliance. The MMF portfolio manager cannot realistically aggregate the reverse repo collateral exposure with securities held within the investment portfolio during trading hours.

IMMFA recommendations

IMMFA believes that it is inappropriate to aggregate the risk exposure of the collateral with the risk of directly owned securities. IMMFA recommends that Article 14(6)(b) be deleted.

IMMFA also recommends that ESMA should have the authority to update the repo collateral requirements from time to time, to reflect developments in the markets.

10) Asset-Backed Commercial Paper

ABCP

Asset-Backed Commercial Paper (ABCP) is 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, such as auto loans, equipment loans, leases, trade receivables and prime residential mortgages, are frequently pooled, sold to this special purpose entity and then used to secure short-term debt sold 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 widely and loosely to describe both vehicles which contributed positively to funding the real economy, but also a range of securitisation structures such as Structured Investment Vehicles (SIVS), which were poorly constructed, many of which were leveraged and which experienced acute funding problems. These latter structures no longer exist.

The value of ABCP

The characteristics which differentiate today's more positive market from the pre-crisis market are:

- ABCP conduits are not leveraged and are secured by diversified pools of short maturity, high quality assets.
- Investors appreciate the transparency and the high credit quality of the assets held by the ABCP conduits.
- Many believe that the ABCP underwriting process, best in class in terms of its credit rigour, should be adopted by other forms of securitization.
- ABCP conduits were one of the few forms of funding available for companies during the recent financial crisis when many other credit markets were frozen.
- The bank that sponsors the ABCP program dynamically manages the asset pools to ensure they contain only assets of high quality.
- No bank sponsored multi-seller ABCP conduit realised a loss during the financial crisis.

A key funding source for European companies

European companies turn to ABCP to improve their working capital by exchanging receivables for funding. This allows them to address their daily capital needs and expand their business, increasing production and employment. While large firms such as Telecom Italia, Generali, Renault, Peugeot, Volkswagen, Lafarge, Teva and Enel all make use of ABCP, in the current market over 50% of asset pool sellers are non rated companies and small and medium-sized companies (SMEs) from across Europe. These companies have limited direct access to capital markets.

ABCP has been growing particularly strongly in countries where bank lending is restricted and where many companies 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 to whom they might find it difficult to lend to directly. The significance of this role is demonstrated by the fact that some ABCP conduits benefit from supranational guarantees.

ABCP is an 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 also 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 adopted a similar strategy to restructure Fortis Bank.

The EC proposals and the risk of unintended consequences

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 would – unintentionally – dramatically reduce this growing source of funding for European companies, since it would substantially limit MMFs ability to invest in ABCP and MMFs represent 50% of all investment in ABCP in Europe.

This unfortunate outcome would be the consequence of three elements of the EC's reform proposals:

- 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. Moreover, consumer debt has a better repayment track record than corporate debt in Europe.
- That legal / residual maturities be restricted to 397 days (Art 10c) when the standard maturities of many types of asset pool (for example, auto loans, leases, SME loans) is five years or less.
- That exposures be limited to 10% or less of the assets of a MMF (Art 14.2). This would significantly reduce the ability of MMFs to invest in ABCP and would also restrict the ability of the MMF manager to diversify the risks within their portfolio.

IMMFA recommendation

The EC's reform proposal would result in a contraction of the ABCP market, which would, in turn, damage the public policy objective of stimulating the wider European economy.

IMMFA makes the following recommendations:

- ABCP conduits with both corporate and consumer receivables should qualify as eligible securitisations.
- The requirement that a MMF's aggregate exposure to securitisations should not exceed 10% of its assets should be deleted.
- The maximum maturity limit of the asset pools financed in ABCP conduits that are eligible for MMFs should be extended to at least 5 years, to match the standard maturities of many types of pools financed in ABCP conduits.

A) Money Market Funds Are Not the Same as Banks

Policy makers recognise that money market funds (MMFs) make a valuable contribution to the European economy, as a reliable source of funding for banks and a wide range of other businesses. They also provide retail and institutional investors with low-cost access to professionally managed investment vehicles, which meet their need for liquidity.

Some policy makers have argued that MMFs are similar to banks, and for this reason they should hold a capital reserve, as banks do, to protect investors from loss if the asset holdings fall in value. However, while the price structure of MMFs might resemble the price structure of a bank deposit, the similarities between a MMF and a bank are only superficial.

MMFs do not engage in liquidity creation and they do not engage in leverage, unlike banks. Furthermore, the difference in legal form between banks and MMFs is important since it provides MMFs with strategies to mitigate run risk, such as the imposition of redemption gates and liquidity fees, which are not available to deposit-taking banks.

These differences are summarised below and set out in more detail on the following page:

Banks	Money market funds
Create liquidity	Manage already extant liquidity
Large asset maturity mismatch, measured in years	Minimal asset maturity mismatch, measured in days
Demand deposit contract	Contingent demand contract
First in queue gets priority	All shareholders to be treated equally
Bank risk is obscure to the depositor	MMF risk is transparent to the shareholder
Banks are leveraged	MMF are not leveraged
Prudential banking regulation includes capital reserves, deposit guarantee scheme, central bank liquidity and bank holidays	Securities markets regulation includes strict rules on asset quality and liquidity, plus redemptions gates and liquidity fees
Banks require capital reserves	MMFs do not require capital reserves

1) Banks gather deposits from investors and then use these funds to make loans to individuals and companies. These loans are often long-term and illiquid. The depositors are paid income generated from these loans, but they are not constrained by their illiquidity; they can demand the return of their capital at any time. The bank has created liquidity that would not otherwise exist in the financial system.

By contrast, MMFs manage investors' extant liquidity. MMFs convert short-term, highly liquid loans into liquid equity for their investors. There is a very modest maturity transformation, typically 25-35 days for Short Term MMF, but no creation of new liquidity.

2) The “demand deposit contract” between a depositor and a bank has existed in standard format for many years. The bank is required to repay depositors on demand and if it cannot do so the bank will be declared insolvent. Those depositors at the front of the queue receive their cash in full but those further back in the queue might receive nothing, creating a very strong first mover advantage.

By contrast, the contract between an investor in a MMF and the manager of the MMF is an “equity contract”, which provides the investor with only contingent access to their capital. In addition the MMF manager has a duty to treat all investors in the MMF fairly, so an investor's place in the queue does not determine whether or not they are repaid. The level of repayments is determined by the performance of the assets in the fund, not by the financial strength of the MMF manager.

3) Information on the quality and riskiness of bank assets is not publicly available; indeed this information is hard to ascertain even for well-informed and experienced financial commentators.

By contrast, information on the assets in a MMF is readily available. The regulations that stipulate what sort of assets may be owned in the fund are publicly accessible, and the MMF managers provide lists of asset holdings to regulators and investors. The risk profile of a bank is obscure to its depositors, whereas the risk profile of a MMF is transparent to its shareholders.

4) Banks use a fractional reserve model, which means that the size of their capital reserve is much smaller than the size of their portfolio of loans - typically only 10% - the balance being comprised of deposit liabilities.

By contrast, MMFs are not leveraged and hold 100% equity. This is comparable to a bank that holds reserves equal to 100% of its loans.

These differences reflect the very different economic functions of banks and MMF. Banks are leveraged and perform liquidity and maturity transformation services in order to promote economic growth through long term investment.

By contrast, MMFs exist to provide reliable funding to banks and other businesses and to provide investors with access to professional credit risk management.

Money market funds are not the same as banks. They should be regulated appropriately, taking full account of their real economic function and legal form.

B) Misconceptions Regarding Capital Buffers in MMFs

Arguments in favour of introducing capital buffers for CNAV money market funds	Counter-argument
<p>The ECB, ESRB, Fed, FSOC and other regulators believe that the introduction of capital buffers is the best approach to regulating CNAV MMFs.</p>	<p>While recognising the value of the views of a wide range of policy makers, IMMFA notes that securities market regulators, who are the day-to-day regulators of MMFs and have the most detailed knowledge of the sector, have taken a different view to some of the central banks.</p> <p>The SEC, for example, came out strongly against capital buffers for MMFs on the grounds that they would be unlikely to prevent runs on MMFs in a period of market distress.</p> <p>The SEC also recognizes the cost implications of capital buffers. The Chief Economist of the SEC concluded that the level of capital buffer sufficient to absorb more than day-to-day price risk would lower returns to the same level as default-free securities. For this reason the SEC regards capital buffers as economically unviable for MMF managers and investors.</p> <p>IOSCO has not come out clearly in favour of capital buffers. IOSCO recommended a move to VNAV “where workable”, but suggested that alternative safeguards should also be considered for addressing risk in CNAV.</p>
<p>CNAV funds with capital buffers would be more resilient at times of market distress.</p>	<p>The SEC notes that capital buffers could “amplify market-wide run risk” if investors conclude, en masse, that these buffers are insufficient. The only sure way to stop investor run is to impose a redemption gate.</p>

<p>A capital buffer of 3% would be effective in preventing “investor runs” from MMFs.</p>	<p>Investor runs typically occur when investors lose confidence in the credit quality of the type of assets which the MMF owns. In a systemic crisis, MMF investors would not be able to make an accurate assessment of the scale of the losses that their MMF might suffer. They would be unable to judge whether or not the 3% capital buffer would be sufficient to cover their risk of loss.</p> <p>If investors decide that there is a system-wide problem in the banking sector, they are likely to conclude that they would be less exposed to risk if their money were invested elsewhere, for example by switching to MMFs that only invest in government securities. This is what happened in the US market in September 2008.</p>
<p>The industry can afford to fund capital buffers.</p>	<p>The MMF industry has been very clear that the introduction of a 3% capital buffer would lead to the closure of CNAV funds.</p> <p>Managers of MMFs would have to increase their fees by around 30 basis points to cover the cost of providing a 3% buffer. This would make the business completely uneconomical. For MMFs sold to institutional investors, current fees are around 8-10 basis points. An increase to 38-40 basis points would lead to a mass exodus by investors.</p> <p>The SEC commented specifically on a 3% buffer, noting that they believe it would be “too costly to be practicable.” Smaller amounts are also likely to be uneconomical, given the requirement to consolidate this capital onto the parent company's balance sheet under CRD IV rules.</p> <p>If capital buffers are introduced, asset management firms will not be able to afford to offer CNAV funds, regardless of the size of the capital buffer and whether the capital buffer is phased in over time.</p>

<p>The European Commission assessed the costs and benefits of capital buffers in its impact assessment.</p>	<p>The Commission’s Impact Assessment and Explanatory Statement that was released with the Regulation contains little research into the viability of capital buffers.</p> <p>There is some discussion of the appropriate level of the capital buffer from a regulatory standpoint, which explains why the 3% figure was chosen. However little work was done to assess whether capital buffers were the most appropriate tool for mitigating risk in CNAV funds.</p> <p>In addition, the assessment of the ability of firms to fund a 3% capital buffer focused on the cost of debt rather than the target return on capital. Once the target return on capital is taken into account it is clear that MMFs with a 3% capital buffer would be uneconomic for both managers and investors.</p>
<p>Capital buffers would lead to lower risk investments portfolios. Fund managers would avoid higher risk investments to lower the possibility of depleting the capital buffer.</p>	<p>MMFs are low risk investments. The recent ESMA guidelines on diversification and liquidity have further lowered the risk profile of MMFs.</p> <p>The SEC notes that capital buffers could lead MMF managers to “hold a higher amount of low yielding investments like cash, Treasury securities, or Treasury repos.” They note that this could lower investors’ returns and add that “there may be an effect on the short-term financing markets if the decrease in demand for short-term securities from money market funds results in an increase in the cost of capital for issuers of commercial paper and other securities.”</p>

<p>If CNAV funds were to close, investors would move their money to VNAV funds, or they would invest directly in the commercial paper market.</p>	<p>A number of client surveys have suggested that the closure of CNAV funds would cause disruption and uncertainty in the market. It is unlikely that most investors would simply switch to VNAV MMFs.</p> <p>For example a J.P. Morgan Asset Management survey found that 74% of clients surveyed would change their MMF usage. This survey found that the majority of investors would move their investments to bank deposits if CNAV were eliminated.</p> <p>A similar survey of European clients by BlackRock found that 50% of investors would stop using MMF completely and a further 21% would reduce their usage of MMF.</p> <p>These investor surveys suggest that the larger, more sophisticated investors might choose to invest in repo directly; but most say that they would move their money to bank deposits. However, many European banks are not willing to accept more wholesale market deposits at present, as they seek to comply with the EU Capital Requirements Directive (CRD IV).</p> <p>CNAV MMFs currently account for close to 50% of the MMF assets in Europe, which equates to €480 billion. If CNAV MMFs were to close, a very large proportion of this money would be switched directly to European banks even though the banks have no wish to receive it.</p>
<p>CNAV MMFs did not make use of redemption gates during the financial crisis, even though they were able to do so under UCITS rules.</p>	<p>Redemption gates were not needed in Europe during the financial crisis because European funds did not face the same volume of outflows as US funds did.</p> <p>UCITS funds are able to introduce gates at present, although these are discretionary. If the use of redemption gates became mandatory, with clearly defined trigger-points based on liquidity levels in the fund, then redemption gates would be used automatically whenever they were necessary.</p>

C) Response to the Harvard Paper

The European Parliament's Committee on Economic and Monetary Affairs (ECON) held a discussion on money market fund (MMF) reform in March 2014. At that meeting, reference was made to a research paper on MMFs published by Harvard in December 2013. This note provides an analysis of that paper.

The paper asks how it is possible to safeguard financial stability whilst preserving the services MMFs provide to investors. It suggests that it is the size of a fund's losses that is likely to trigger a run by investors, rather than the size of the investors' anticipated loss. Consequently if the fund has a buffer to absorb part of the loss, the paper suggests that the likelihood of a run will be reduced. The experience of most MMF experts is that the chances of a run are dependent on investors' perceptions of the strength of the underlying assets held in the fund. In distressed markets it is unlikely that investors will take much comfort from the thought that some of these losses might be absorbed by a capital buffer.

The Harvard paper is principally concerned with the US market and yet, although published in December 2013, it does not take into account the most detailed reports on MMF in the USA, which were published by the SEC in November 2012 and June 2013 (this latter report 698 pages). It is important to note that the options the Harvard paper considers are quite different from the proposals made by the European Commission (EC) and SEC. The solution the paper advocates includes a subordinated share class (to be sold into the market or funded by the MMF sponsor) to provide a first-loss capital buffer. This is rather different from the 3% permanent capital buffer proposed by the EC. In its reports of November 2012 and June 2013, the SEC considered a variety of capital solutions very carefully, including subordinated debt, and rejected them all as ineffective for investment funds. It rejected a capital buffer similar to that proposed by the EC as the size of the buffer required to cover a "run" in a systemic crisis would effectively eliminate MMF. It rejected subordinated debt, which would in theory absorb some realised losses, on the basis that it would not prevent runs but would rather create conflicts of interest between the investors in the subordinated debt and the investors in the MMF.

The SEC is focusing instead on market finance based solutions, including redemption gates and liquidity fees, which in common with MMF experts, it believes will be more effective in addressing runs. Prudential regulation is a blunt and ineffective tool for investment funds. Gates and fees have been designed by securities markets regulators precisely because they are effective for investment funds. Rather than relying on *ex ante* incentives which might, but might not influence investor behaviours, gates and fees are tools which force changes in investor behaviour at times when markets are distressed. It is notable that the more recent FSB publications highlight liquidity measures, including gates and fees, as a solution for low risk funds subject to runs. Interestingly, the Harvard paper notes more than once that there is just as much chance of runs in VNAV as in CNAV MMF. For example "the stable versus variable NAV distinction [in Europe] explained none of the cross-sectional variation in withdrawal rates from European MMFs following the failure of Lehman Brothers in September 2008"; and again, "there is a possibility that a move to a floating NAV could actually increase the probability and severity of MMF runs".

Finally, the Harvard paper ignores the fact that the cause of the MMF run in September 2008 lay in the banking system. Clients feared that a large number of banks were insolvent so they switched from bank exposure (Prime MMFs) into sovereign exposure (Government MMFs). Investors' actions were driven by their views on the creditworthiness of the assets held in the MMF and not their views on MMF accounting policies or capital reserves. .

D) Response to the Witmer Paper

Form over substance: mistaken proposals for the reform of Money Market Funds

Introduction

One of the repeated claims made by proponents of the reform of Money Market Funds (MMFs) is that funds with constant net asset values (CNAV) are more susceptible to major investor redemptions - or "run risk" - than funds with variable net asset values (VNAV). Consequently, some policy makers have proposed the forced conversion of all CNAV funds to VNAV; others, such as the European Commission, have proposed that CNAV funds hold a capital buffer of 3% to provide protection against the risk of a run. The research upon which this claim is based turns out to be far less robust than policy makers have assumed.

The EC's current reform proposals for MMFs are likely to be highly disruptive of the MMF industry, the cost of which will largely be borne by customers. These economic burdens are not only unwelcome but also unnecessary, since the reform proposals have been designed to solve a problem that does not exist.

The Witmer paper

In August 2012, the Bank of Canada published a research paper by Jonathan Witmer from their Financial Markets Department, with the title: "Does the Buck Stop Here? A Comparison of Withdrawals from Money Market Mutual Funds with Floating and Constant Share Prices" (Working Paper 2012-25). This paper is cited in the EC *Impact Assessment*, published in September 2013 to accompany the "Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds" (SWD 2013, 315). Witmer's paper appears to be a straightforward example of finance research: it contains a number of formal equations, makes reference to recognised statistical techniques, and roughly half of its pages are comprised of scholarly references and tables of results.

The authors of the *Impact Assessment* quote Witmer's conclusion, namely that comparing CNAV funds with VNAV funds, he found that CNAV funds "are more likely to experience sustained outflows" (p.11-12). The authors of the *Impact Assessment* do not say whether they made any attempt to verify the credibility of this finding, nor whether they considered an alternative explanation for the evidence. This is unfortunate because the Witmer paper suffers from a number of weaknesses that make it unreliable as a basis for policy making.

a) sample size biases

Witmer compares CNAV and VNAV funds denominated in US dollars (\$) and in Euro (€). These funds can be disaggregated according to country of domicile and according to whether they are sold to retail or institutional investors. Witmer's data samples for \$ and € funds are both highly skewed, a fact that he does not discuss in the body of his text. These sample skews render his conclusions vulnerable to bias.

-- The sample of € funds contains 401 entities, of which 389 (or 97%) are VNAV funds and only 12 (3%) are CNAV. Moreover, of these CNAV funds only 5 (1.2%) are offered to institutional investors. The sample is heavily skewed to VNAV retail funds.

-- In the sample of \$ funds Witmer has the opposite problem: his sample contains 247 entities, of which 58 are VNAV funds (23.5%), however the assets in these funds amount to only \$48.7bn out of a total of \$1071.3bn within the sample (or 4.5%). In other words, the \$ sample is heavily skewed to large CNAV funds.

-- It seems highly likely that the material differences in sample sizes of CNAV and VNAV funds, in both currencies, invalidate any general conclusions that might be drawn from the data sample about the relative performance of these funds types.

b) definitional shortcomings

Witmer introduces a series of definitions in his paper that suggest little understanding of the design and behaviour of MMFs in practice.

-- He defines "sustained withdrawals" as outflows of more than 1% of net assets over a consecutive 3-day period. Yet this would represent "business as usual" for many CNAV funds, particularly those that are used by corporate treasurers to manage their daily liquidity. IMMFA funds are required to ensure that at least 20% of their assets mature within one week, so a consecutive 3-day period of 1% outflows is quite evidently not a serious measure of redemption pressures or run risk for IMMFA funds.

-- During the period that Witmer's research covers, many funds in Europe used the name "money market fund" even though their fund guidelines were very different from each other. IMMFA funds must keep the weighted average life (WAL) of their funds at less than 120 days, whereas during the 2008-09 financial crisis some European VNAV money market funds had WALs of over 800 days.

-- This strongly suggests that Witmer's statistical tests are of dubious worth. His test for "sustained withdrawals" is set at too low a level to be a serious measure of fund performance at times of market stress. His comparison of the CNAV and VNAV funds in Europe ignores major differences in fund guidelines between these funds: it is not a comparison of equivalents but a comparison of apples with lemons.

c) interpretive weaknesses

Witmer refers in his conclusions to "anecdotal evidence", which he proceeds to dismiss. However, his research suffers repeatedly from a lack of interpretive understanding of how MMFs work and why investors behave as they do.

-- In Europe, retail investors tend to use VNAV funds to provide higher returns but with higher risks. They treat MMF as the equivalent of long term savings accounts. For short term cash management they use banks which offer the benefit of deposit insurance.

-- By contrast institutional investors in Europe, who do not have access to deposit insurance, use CNAV funds for short term cash management. They prefer MMFs to bank deposits because MMFs offer instant credit diversification.

-- CNAV and VNAV funds are managed in different ways to accommodate the different goals of different types of investors, a point that Witmer does not acknowledge.

d) failure to ask the right questions

Underlying these concerns with the Witmer paper is a failure to ask the right questions about investor behaviour. During the financial crisis, when investors sold MMFs what did they do with their cash?

-- In the US, institutional and (to a lesser extent) retail investors switched into MMFs holding only government debt. This was a rational response to heightened concerns about US banks, following the collapse of Lehman Brothers.

-- In Europe, some institutional investors switched from MMFs that were exposed to US bank debt for the same reasons. However, most retail investors did not switch because there was no expectation that any European government would allow one of its major banks to fail.

-- The behaviour of investors was principally determined by their expectations of government support for their national banking sector. The pricing structure of the MMF was an irrelevance.

Conclusion

The EC "Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds" contains proposals that would lead to significant and expensive upheaval within the MMF industry, and many of these costs will be borne by European companies and pension funds. Yet the research used to support these reforms does not stand up to critical scrutiny.

E) Investment by CNAV MMF: - Beneficiaries by Country and by Institution

The following tables examine the countries and institutions in which the funds in CNAV funds are invested. The funds taken into account are European domiciled CNAV MMF as at end October 2013.

Analysis by Country:

Euro Prime CNAV MMF

Country	Total allocation	Banks	Sovereigns	Corporates
France	34.0%	28.4%	4.6%	1.0%
Germany	15.5%	14.0%	0.7%	0.7%
UK	10.2%	10.2%		
NL	9.8%	9.1%	0.6%	0.2%
Sweden	6.6%	6.6%		
Japan	6.1%	5.9%		0.2%
USA	5.7%	2.7%		3.0%
Rest	12.0%			
Total	100%			

Sterling Prime CNAV MMF

Country	Total allocation	Banks	Sovereigns	Corporates
UK	15.7%	15.1%	0.4%	0.2%
France	15.5%	14.0%	1.5%	
Germany	12.1%	11.6%		0.5%
NL	10.6%	10.6%		
Japan	9.1%	8.1%		1.0%
Sweden	8.7%	8.7%		
USA	6.5%	5.5%		0.7%
Australia	5.2%	5.2%		
Rest	16.6%			
Total	100%			

US Dollar Prime CNAV MMF

Country	Total allocation	Banks	Sovereigns	Corporates
France	17.0%	16.1%	0.8%	0.1%
USA	15.2%	7.4%	5.7%	2.1%
Japan	10.7%	10.2%		0.5%
Sweden	9.8%	9.8%		0.1%
Australia	9.1%	9.1%		
Canada	7.9%	7.9%		
Germany	7.8%	7.7%		0.1%
UK	7.3%	7.2%		0.1%
NL	5.1%	5.1%		
<i>Rest</i>	10.1%			
Total	100%			

Source: CraneData

Analysis by Issuer:

<u>Top 20 entities funded by Prime CNAV MMFs</u>		<u>Top 20 entities funded by Prime and Government Liquidity CNAV MMFs</u>	
Issuer	Total (€bn)	Issuer	Total (€bn)
1. Crédit Agricole	13.8	1. US Treasury	24.6
2. FMS Wertmanagement	13.2	2. Crédit Agricole	15.5
3. Société Générale	11.6	3. BNPParibas	15.5
4. Rabobank	11.3	4. FMS Wertmanagement	13.6
5. Sumitomo Mitsui Banking Co	10.9	5. Société Générale	13.6
6. BNPParibas	10.5	6. Barclays	12.3
7. Bank of Tokyo Mitsubishi	10.3	7. Deutsche Bank AG	12.0
8. Nordea Bank	9.6	8. Rabobank	11.3
9. HSBC	9.4	9. Sumitomo Mitsui Banking Co	10.9
10. Deutsche Bank AG	9.2	10. HSBC	10.6
11. ING	8.7	11. Bank of Tokyo Mitsubishi	10.3
12. Barclays	8.0	12. Nordea Bank	9.6
13. Svenska Handelsbank	7.6	13. ING Bank	8.8
14. Natixis	7.6	14. JPMorgan	8.2
15. Crédit Mutuel	7.1	15. Svenska Handelsbank	7.6
16. JPMorgan	7.0	16. Natixis	7.6
17. Skandinaviska Enskilda Bank	6.8	17. Crédit Mutuel	7.1
18. Lloyds TSB Bank	6.7	18. Skandinaviska Enskilda Bank	6.8
19. Standard Chartered Bank	6.6	19. Lloyds TSB Bank	6.7
20. National Australia Bank	6.4	20. Standard Chartered Bank	6.6

Source: Crane Data, October 2013

F) Members of IMMFA at June 2014

Full Members of IMMFA are operating at least one Aaa rated constant NAV MMF based in Europe.

These firms have just under €480 billion AUM in IMMFA compliant CNAV funds and account for approximately half of the MMF AUM in Europe at 30th June 2014.

Aberdeen AM	Ignis AM
Amundi AM	Invesco
Bank of America AM	J.P. Morgan AM
BlackRock	Legal and General IM
BNP Paribas IP	Morgan Stanley IM
BNY Mellon AM	Northern Trust GI
Deutsche AM	State Street GA
Federated	SWIP
FIL FM	UBS Global AM
Goldman Sachs AM	Western AM
HSBC Global AM	

Contact Details

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