

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

IMMFA Position on Capital Buffers

IMMFA appreciates and supports the stated objective of the European Commission not to prohibit one or other model of MMF. However a 3% capital buffer will, almost certainly, eliminate CNAV MMF given either a MMF provider's expected return on capital or the cost of the capital itself. Even a significantly lower capital buffer will almost certainly lead to increased concentration amongst remaining CNAV MMF providers.

Putting these factors to one side, a 3% capital buffer will either significantly reduce banks' Core Tier One (CT1) capital - when the policy objective is for banks to increase capital - or lead to greater deleveraging, reducing further the provision of credit to the European economy.

The consequences of such a high capital buffer - the elimination of CNAV MMF, a significant reduction in CT1 capital and/or funding to the real economy - seem disproportionate, all the more so as capital alone is not designed to address 'runs' (either on banks or on MMF) in times of systemic market stress. Rather, the capital buffer may cause some MMF providers to convert from CNAV MMF to VNAV MMF, causing a convergence in the European industry around VNAV MMF. MMF will be no more resilient to 'runs' in times of systemic stress as a result and investors in CNAV MMF may not have access to a MMF as an investment option and the benefits this brings them.

IMMFA, along with the other major industry associations, strongly believes that the most effective policy to mitigate such runs is redemption gates and/or liquidity fees.

1. A 3% capital buffer will eliminate CNAV MMF

A MMF provider has to earn a sufficient rate of return on the capital it puts at risk, especially capital that is in a first loss position, as we understand the position of the proposed buffer to be. The return on capital expectation of bank sponsors is typically from 10% to 15%. Assuming that sufficient capital would be available, a 3% (300bp) capital buffer would result in a return on capital substantially under this hurdle rate given average retained fees of 0.08% (8bps) by IMMFA members.

(8bp return on 300bp capital = $8 / 300 = 2.67\%$ return)

Viewed another way, managers would have to increase their retained fees by at least 30bp to cover the cost of providing 3% capital. This level will not be borne by the market.

Beyond this, the 3% capital buffer might lead to the MMF provider being deemed to have a 3% economic interest in the MMF, for example, if it receives interest on the capital buffer or is likely to receive back the capital in the event that the MMF is wound up. If so, the MMF will have to be consolidated on the balance sheet of the MMF provider, with offsetting assets and liabilities reflecting the assets under management of the MMF. 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 (8% Pillar One haircut) to be injected in the form of CT1 capital. Thus the actual amount of CT1 capital required will be 3% as a minimum but could be over 8%. This could impact the credit ratings of some MMF providers and is likely to increase the resolve of a CNAV MMF provider either to close their CNAV MMF or to convert to VNAV MMF.

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 BRRD 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 MMF to their investors.

Finally, such a capital buffer would advantage bank providers over independent asset managers given the significantly higher cost of capital and return on capital expectations of independent asset managers compared to banks. For example, the weighted average cost of capital of independent asset managers is typically around 10% whereas banks generally have a cost of capital in the range of 2% to 4%. This treatment would seem to run counter to competition policy and the objective of facilitating a greater balance between bank finance and market finance in Europe.

2. A 3% capital buffer – were this feasible from an economic perspective - would significantly reduce the availability of CT1 capital and/or reduce funding to the real economy

Based on global assets under management, it is estimated that approximately half the banks acting as MMF sponsors would suffer a reduction in CT1 of over 1% with the custodian banks suffering falls of between 2% and 6%. These banks would have to decide whether to raise fresh capital to replenish their CT1 or, alternatively, to engage in significant deleveraging.

A 3% capital buffer would require European domiciled CNAV MMF to raise €14bn, €10bn by banks and €4bn by independent asset managers. Assuming banks are currently levered x20 – x25, reassigning the capital from other business to cover the MMF buffer would withdraw €200bn – €250bn from the European economy. The actual impact on CT1 capital might be further multiples of the estimate above if consolidation is required as set out in section 1.

3. Even a substantially lower capital buffer would lead to greater concentration amongst CNAV MMF providers

A significantly lower capital buffer, as set out in the IOSCO Guidelines, will allow some MMF providers to continue to manage CNAV MMF. Of those willing to put up capital, it will favour institutions with large balance sheets and/or a lower cost of capital or those with lower return on capital expectations. Regulation will thereby significantly reduce investor choice. It is likely to mean that some of the industry will convert to VNAV MMF, leading to an increased level of concentration in the remaining CNAV MMF market. Consequently, the CNAV MMF industry could spark competition concerns as has been seen with CRAs and audit firms.

4. Capital alone 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:

- i) central bank liquidity and
- ii) suspension of convertibility (‘bank holidays’).

The same is true for MMF.

Capital reserves will be insufficient to protect MMF from runs if the investors in MMF fundamentally doubt the quality of the credits held in the MMF portfolio (that is, when a large part of the banking system is thought to be insolvent). Unlike banks, in such situations, MMF do not have access to central bank liquidity, nor should they as they are investment and not banking products. They are, however, able to suspend convertibility, literally stop or slow redemptions, via redemption gates and liquidity fees - the securities market equivalent of bank holidays. Indeed, the prospectuses of most MMF already provide for such measures.

5. Industry convergence around VNAV MMF will not address systemic concerns around ‘runs’ in MMF

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.

6. Redemption gates and liquidity fees are the most effective way of mitigating runs on MMF

Triggered by the Board of a fund and based on objective criteria set out in regulation, a redemption gate and/or liquidity fee could be imposed to disincentivise investors from irrational flight. Clients who truly need liquidity to meet specific payments or clients who decide they want their cash can access it. However, they must pay a liquidity fee for this access just as they would suffer a bid-offer spread were they to sell securities directly in the market.

Such a fee would keep the remaining investors in the fund whole and, in this way, create a last-mover rather than a first-mover advantage. Properly constituted, a liquidity fee will act as a circuit-breaker – a decelerant and not an accelerant of client redemptions.