IMMFA

INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

BCBS Consultative Document December 2015: *Identification and measurement of step-in risk*

The Institutional Money Market Funds Association Ltd ("IMMFA") is pleased to submit its comments on the Basel Committee's consultative document.

IMMFA represents the European institutional money market fund industry that sponsors and promotes investment funds based on providing a constant Net Asset Value per share to investors. In practical terms this means offering an investment product that, without guaranteeing a result, expects to return €1 plus yield (calculated daily) for each €1 invested.

Our interest in the consultation is focused on "step-in" support for money market funds ("MMF") specifically.

IMMFA money market funds

The MMFs promoted by IMMFA members are open-ended investment (or "mutual") funds domiciled in the European Union.

Most take the form of a UCITS[1] investment fund. As well as complying with the UCITS' legislative provisions, the MMF are subject to formal guidelines issued by the European Securities and Markets Authority[2] ("ESMA") in relation to MMF investment

[1] UCITS: Undertakings for Collective Investment in transferable securities – the first Single Market directive implemented in the European Union in 1983, covering the form, governance and content of investment funds. It has been updated on several occasions, most recently and substantially in July 2009

[2] ESMA (formerly CESR) guidelines MMF: https://www.esma.europa.eu/sites/default/files/library/2015/11/10-049_cesr_guidelines_mmfs_with_disclaimer.pdf

risk in particular. In its guidelines ESMA draws a distinction between what are termed Short Term MMF and between other MMF. IMMFA constant NAV MMF are all ESMA Short Term MMF.

These MMF invest in high-quality very short-term debt, such as government bonds, prime debt, certificates of deposit and high quality asset backed commercial paper. The funds will also make use of reverse repo, lending cash to the market and taking security over very short term high quality paper, usually government debt. Use of repo is not permitted (under the Code of Practice operated by IMMFA).

Typically the investor profile of these MMF includes institutions such as corporations, including banks and insurance companies, pension funds, charities, local authorities and public bodies.

The funds offer cash management, effectively intermediating between investors and issuers in the money markets (prime and government), as well as providing credit risk diversification from deposit taking at banks.

Importantly, the MMF offer same day liquidity to the unit/shareholders in the fund.

Sponsor support

The Basel Committee addresses sponsor support emanating from the banking sector. However, many of the MMF in IMMFA membership are promoted either by independent asset management houses, or by asset managers owned within a non-bank group, typically with an ultimate parent that is an insurance company.

This is relevant in that, whilst banking reforms in some jurisdictions have addressed issues relating to step-in risk, the draft EU reforms in relation to MMF address aspects of step-in for all sponsored MMF, not just those which are bank-sponsored.

Bank sponsored MMF

Bank reform has been undertaken in several jurisdictions, covering most global banking groups. The aspects of bank reform relevant to step-in risk for IMMFA funds are described below.

US Volcker Rule

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the so-called “Volcker Rule”) enacts amendments to the US Bank Holding Company Act of 1956. It explicitly prohibits banking entities from acquiring or retaining an ownership in, or sponsoring, hedge funds and private equity funds (called “covered funds”). In addition, under the Volcker Act Super 23A provisions, a banking entity is

prevented from extending credit to, or investing in, a covered fund that is advised, managed or sponsored by an affiliate. Under the Super 23B provisions, all prime brokerage arrangements between a banking entity and its covered fund affiliate must be at arm's length.

The extra-territorial application of the Volcker Rule in respect of covered funds is fiercer: whereas many mutual funds domiciled in the US under the 1940 Act are exempt from the application of the Volcker Rule, this consideration is not applied to non-US mutual funds such as those set up under EU UCITS and AIFM regulation.

In practical terms this means that investment funds sponsored and managed by asset management companies within banking groups that have a US nexus under the Bank Holding Company Act are prohibited from undertaking any form of step-in for these funds, including for MMF. Because of the very wide extra-territorial application of the Volcker Rule, many banking groups, including European-based ones, are impacted by the Volcker Rule, even when on the face of it they are not US banking groups.

We believe that BCBS should recognise the legislative impact, both within the US and extraterritorially, of the Volcker Rule and accept that in these circumstances the risks associated with step-in have been dealt with.

UK Vickers Rule

In the UK, bank reform legislation has progressed with a similar intent to the Volcker Rule, but a different focus. In this case, the aim has been to ring fence specified banking activities and, within the ring fence, prevent the organisation from providing step-in support to non-ring fenced activities, such as MMF.

As with the Volcker Rule, we suggest that BCBS should recognise the legislative impact of the UK ring fencing arrangements and accept that for these banking entities step-in risk has been dealt with.

EU bank reform proposals

The EU-wide bank reform proposals are still under consideration.

However, like the UK, some EU countries have also introduced bank reform legislation. In these cases, where step-in has been addressed, BCBS should provide a mechanism to recognise that the risk has been dealt with.

European Union proposed Money Market Fund Regulation

Increased risk controls for MMF

In the EU, the European Commission proposed a Regulation on MMFs in 2013 (this type of legislation will, when concluded, apply directly in each of the 28 Member States of the European Union). The Regulation proposed stringent new rules to strengthen all aspects of the MMF risk management:

- in respect of liquidity management, MMFs would be required to have at least 10% of their portfolio in assets that mature within a day and another 20% that mature within a week;
- concentration and diversification rules will apply, for example exposure to a single issuer will be capped at 10% of the MMF's portfolio;
- the Commission proposes that funds operating with a constant net asset value should hold a capital buffer of 3% of the value of the fund: we note that this provision differs markedly from the reforms enacted in the USA.

Since the Commission put forward its proposal, the European Parliament has concluded its review of the legislation and voted to make amendments to the Commission's text. If accepted, these will impose:

- more stringent requirements in relation to liquidity risk management, with 15% of assets required to mature within a day and 30% to mature within a week
- more stringent concentration and diversification rules, for example exposure to a single issuer will be capped at 5% of the MMF's portfolio
- the replacement of capital buffers with other stringent risk controls for a new type of MMF called a Low Volatility NAV MMF, including in particular a 20 basis point "collar" beyond which the NAV of the fund may not vary at any time (from the stable US$1/€1/£1 per fund unit) – without reverting to a variable NAV; and
- the Parliament also established a Government Debt MMF which bears many similarities to the sovereign MMF resulting from the US reforms.

The European negotiations are continuing actively. Although the legislation is not yet concluded, as with the US it is designed to allow the relevant EU countries to meet their G20 commitments in regard to this aspect of shadow banking.

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Although the EU legislation is still pending, we would like to highlight its specific intention to tackle "MMF's propensity to require sponsor support to stabilise redemptions at par" – i.e. step-in risk.

The Commission proposed that no sponsor support should be allowed for constant NAV MMF that maintained the proposed capital buffer as a remedy, save in truly exceptional circumstances. The European Parliament went further and proposed a ban on all sponsor support for all MMF in all circumstances.

In each case, we suggest that, once enacted, step-in risk would effectively be dealt with for MMF.

The various new rules in place or under way will significantly increase the resilience of MMF and reduce the incentives for investors to withdraw in a crisis, thus also substantially limiting the need for step-in. The EU Money Market Fund Regulation is also likely to address step-in risk explicitly in relation to MMF and in this case it should be recognised that all sponsor risk is dealt with, not just that relating to bank sponsors.

It is important that the Basel Committee should recognise that these legislative initiatives have been done and that there is no need to impose a set of obligations in addition.

Jane Lowe
Secretary General
IMMFA

Tel: +44 (0)20 7269 4625
janelowe@immfa.org