Why 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 source of short-term finance for banks and a wide range of other businesses. They also provide retail and institutional investors with a low-cost, professionally managed investment vehicles for their liquidity needs

Some policy makers have argued that MMFs are similar to banks, and for this reason they should hold a capital buffer, 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 the two products are only superficial.

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

These differences are summarised in the table 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, deposit guarantee scheme, central bank liquidity and bank holidays	Securities markets regulation includes well-defined restrictions on asset quality and liquidity, 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 short-term funds 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.