IMMFA

INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

4th September 2013

The European Commission has today released the proposal for a new Regulation for money market funds: “Regulation of the European Parliament and of the Council on Money Market Funds”.

IMMFA members are committed to providing high quality, effective products but this ill-considered Regulation will effectively mandate a conversion to variable NAV MMF to the detriment of investors, issuers and the economy in general.

IMMFA supports the introduction of minimum liquidity requirements, “know your client” policies, the use of trigger-based liquidity fees and gates and enhanced transparency. These reforms would make MMF even stronger and meet regulators’ desire to reduce run risk in MMF whilst maintaining them as an effective product for investors.

“Some of the measures in today’s EC proposal will make a positive contribution to the robustness of money market funds, but there are several which are extremely unhelpful, to investors and to the short-term debt markets in general” said Susan Hindle Barone, Secretary General of IMMFA. **“We reject the assertion that there is a greater degree of systemic risk inherent in constant NAV money market funds. The European Commission has not demonstrated that CNAV funds are more susceptible to run-risk than VNAV funds and the discrimination between these two accounting techniques is unjustified.”**

IMMFA does not believe that requiring a 3% capital buffer for CNAV MMF will enhance systemic stability.

- Holding capital is inappropriate for investment funds and would fundamentally change the nature of the relationship between the investor, the fund manager and the CNAV fund.
- With the requirement for a 3% capital buffer, IMMFA expects that CNAV providers will convert their funds to VNAV. It is uneconomic for an asset manager to hold 3% capital against a MMF.
- Even assuming that a 3% capital buffer were affordable, its imposition 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 result is a *de facto* abolition of CNAV funds leading to fewer choices for investors.

The proposals conflict with three of the FSB’s five key principles (appended below) for new regulatory measures aimed at shadow banking concerns.

Focus: The EC has not demonstrated that CNAV funds are more susceptible to run-risk than VNAV funds; the 3% buffer requirement does not target a cause of systemic weakness.

Proportionality: With no material difference in risk between these two types of fund, it is disproportionate to impose a 3% capital buffer on one type but not on the other.

Effectiveness: Given the SEC's decision to reject the use of capital buffers for US MMF, there is now a serious risk that cross border arbitrage opportunities will be created. There are no material differences between the money markets in the US and the EC to justify such a markedly different regulatory response.

Removal of Amortised Cost Accounting

Amortised cost accounting is a pragmatic way to evaluate the fair value of money market instruments, is compliant with UCITS and has been accepted by the FASB as compliant with GAAP. The prohibition of amortised cost accounting will make it impractical to operate MMF and offer liquidity on a 'same-day' basis, damaging the value money market funds have for investors and therefore the value the funds have for the broader economy.

Not a Systemic Source of Funding

The EC document states that MMFs hold 38% of the short term debt issued by the banking sector and account for 22% of short term debt securities issued by either governments or by the corporate sector. However, based on ECB, Bank of England and ICMA data, IMMFA calculates that in total MMFs represent only 6% of the EUR short term funding market and 8% of the sterling short term funding market (see "IMMFA Summary Paper" below for sources).

Extensive Practical and Operational Difficulties

Beyond these fundamental issues, there are numerous other prescribed changes which would make the continued operation of MMF difficult whilst apparently achieving little in terms of the stated aims. These would include:

- Removal of fund ratings – problematic to investors
- An excessively prescriptive credit analysis process
- Restriction on eligible assets – specifically the restrictions on ABCP

Finally, the transition period for these changes is given as 6 months. This will not be practicable given the extensive operational and educational changes which would be necessary.

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Further Information:

1. The Institutional Money Market Funds Association ("IMMFA") has sought to engage with the key stakeholders in the official sector in order to demonstrate the significant benefits provided by money market funds (MMF) to the broader economy – providing investors with a high quality investment product in which to place their surplus cash, and in adding liquidity and stability to the short-term debt markets.

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2. The likelihood of investors redeeming from either constant net asset value (CNAV) or variable net asset value (VNAV) MMF is determined by the quality of the assets held by the fund, not the accounting procedure used. There is no material difference between the underlying assets of the two types of fund 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.

3. In October 2011, the Financial Stability Board set out 5 key principles which should guide those implementing new regulatory measures aimed at addressing concerns related to shadow banking. (See full excerpt appended at the end of this document)

(i) ***Focus*: Regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates⋯.**

(ii) ***Proportionality*: Regulatory measures should be proportionate to the risks shadow banking poses to the financial system**;

The EC has failed to produce compelling evidence that CNAV funds are more susceptible to run-risk than VNAV funds; indeed they have ignored evidence to the contrary. (see "Bank Runs, Money Market Funds and the First Mover Advantage" below) To require 3% capital for CNAV funds but not for VNAV funds, without evidence that there is a material difference in risk between the two types of fund represents a failure to develop regulation to the standards set by the FSB. Given the absence of a material difference in risk presented by these two types of fund, it is disproportionate to impose a 3% capital buffer on one type but not on the other (see IMMFA Position on Capital Buffers below).

(iv) ***Effectiveness*: ... to avoid creating cross border arbitrage opportunitie**s...
Given the SEC's decision to reject the use of capital buffers as part of the MMF reform process in the US, a decision that is based upon much more detailed and consultative research than the current EC proposals, there is now a serious risk that cross border arbitrage opportunities will be created, in breach of the FSB's stated aim. There are no material differences between the money markets in US and the EC which would justify such a dramatically different regulatory response.

4. Removal of Amortised Cost Accounting - Unlike equity and some fixed income markets where quoted prices are readily available, quoted prices for money market instruments are rarely available. Money market investors are typically 'buy and hold' investors meaning that they rarely sell assets before maturity.
Data from a broad sample of IMMFA MMF show that, on average, the annual value of sales before maturity is just 0.327% of the annual value of maturities. (See "The Use of Amortised Cost Accounting in Money Market Funds" below)

In the absence of traded or quoted prices, amortised cost accounting is a pragmatic way to evaluate the fair value of money market instruments. Amortised cost accounting is widely used in the EU, is compliant with UCITS and has been accepted by the FASB as compliant with GAAP. It is also used in the financial statements of banks to value loans and certain other assets. Money market funds are not outliers in their use of amortised cost accounting.

The prohibition of the use of amortised cost accounting will make it impractical to operate MMF on a 'same-day' basis, damaging the value money market funds have for investors and therefore the value the funds have for the broader economy.

5. Removal of Fund Ratings - The complete restriction on the soliciting of external fund ratings is likely to be a difficult burden for investors who value rating agencies' independent oversight of MMF.

6. Prescribed Credit Analysis Process - The Regulation specifies in detail the analytical process which a fund manager must employ when assessing the credits which it wishes to consider for investment. This proposal is illogical in view of the investment objectives of MMF and is overly prescriptive.

7. Restriction on Eligible Assets - The new Regulation strictly limits the assets which are eligible for inclusion in a MMF. The narrow description of 'securitisations' affects the ability to invest in ABCP and has potential to hamper this funding stream to the wider economy.

8. The EC document states that MMFs hold 38% of the short term debt issued by the banking sector and account for 22% of short term debt securities issued by either governments or by the corporate sector. However, based on ECB, Bank of England and ICMA data , IMMFA calculates that in total MMFs represent only 6% of the EUR short term funding market and 8% of the sterling short term funding market. This supports the ECB's conclusion that "MMFs do not seem to play a sizeable role at an aggregated level in the euro area". (see "IMMFA Summary Paper" below for more detail)

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The following documents provide more extensive background on many of the points made above:

IMMFA Position on Capital Buffers – May 2013
http://www.immfa.org/assets/files/publications/IMMFA%20Position%20on%20Capital%20Buffers%20-%20May%202013.pdf

IMMFA Summary Paper on Money Market Funds - February 2013
http://www.immfa.org/assets/files/publications/IMMFA%20Summary%20Position%20Paper%2014th%20Feb%202013.pdf

The Use of Amortised Cost Accounting in Money Market Funds – January 2013
http://www.immfa.org/assets/files/publications/IMMFA%20The%20use%20of%20amortised%20cost%20accounting%20by%20MMF.pdf

Bank Runs, Money Market Funds and the First Mover Advantage – January 2013
http://www.immfa.org/assets/files/publications/Bank%20Runs%20Money%20Market%20Funds%20and%20the%20First%20Mover%20Advantage%20%28v2%20January%202013%29.pdf

Excerpt from the Financial Stability Report:

Shadow Banking: Strengthening Oversight and Regulation
Recommendations of the Financial Stability Board
27 October 2011

3. Proposed regulatory measures to address concerns related to the shadow banking system

3.1 General principles for regulatory measures related to shadow banking

The shadow banking system includes a wide variety of activities and entities. As a result, a single regulatory approach for all components of the shadow banking system would not necessarily be appreciated. Rather, differentiation is necessary to account for differences in business models, risk characteristics and contribution to systemic risk. **In designing and implementing the regulatory measures for shadow banking, regulators should apply the following general principles:**

(i) ***Focus*: Regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates.** When designing the regulatory measures, regulators should also be mindful of their potential impact and possible unintended consequences, such as a deterioration in market functioning. Authorities should also recognise that a variety of possible regulatory and supervisory measures might effectively mitigate the identified risks;

(ii) ***Proportionality*: Regulatory measures should be proportionate to the risks shadow banking poses to the financial system**;

(iii) ***Forward-looking and adaptable:* Regulatory measures should be forward looking and adaptable to emerging risks.** Regulatory measures should not focus solely on risks that became apparent in the recent crisis, but also address issues that may arise as financial markets adapt and evolve to new conditions, such as changes in financial institutions' incentives in response to the Basel III framework;

(iv) ***Effectiveness*: Regulatory measures should be designed and implemented in an effective manner, balancing the need for international consistency to address common risks and to avoid creating cross border arbitrage opportunities against the need to take due account of differences between financial structures and systems across jurisdictions**; and

(v) ***Assessment and review:* Regulators should regularly assess the effectiveness of their regulatory measures after implementation and make adjustments to improve them as necessary in the light of experience.** Authorities should share their experiences in order to learn from each other and to develop best practices.