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European Fund and Asset Management Association

EFAMA's Comment to the
President's Working Group on Financial Markets on
Money Market Fund Reform Options
Submission to the Securities and Exchange Commission
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Background

EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 45 corporate members more than EUR 13 trillion in assets under management, of which approximately EUR 7.5 trillion was managed by investment funds at the end of June 2010.[1] Out of this total, EUR 1,243 billion was managed by money market funds (MMFs) domiciled in the European Union.

With EUR 815 billion in assets under management, floating NAV MMFs held a 66% share in the European MMF market at end June 2010, with constant NAV triple-A MMFs managing a total of EUR 418 billion of assets. The top three domiciles in terms of MMF assets were France (35%), Ireland (28%) and Luxembourg (25%) at end June 2010.

MMFs in Europe are usually authorized under the Undertakings for Collective Investments in Transferable Securities (UCITS) Directive[2]. In addition to respecting the UCITS Directive requirements, the constant NAV triple-A MMFs adhere to the IMMFA Code of Practice.[3]

European MMFs in the Financial Crisis in 2007-2008

The global financial crisis caused strains among MMFs in Europe. The first impact of the financial crisis became apparent in mid-2007 after the outbreak of the subprime when the so-called "*enhanced money market funds*", which used the "money market" fund label in their marketing strategies while taking on more risk than traditional money market funds,

[1] For more information about EFAMA, please visit www.efama.org.
[2] EU Directive 2009/65/EC of 13 July 2009 (UCITS IV).
[3] IMMFA is the Institutional Money Market Funds Association, which is the trade association representing the European triple-A rated money market funds industry.

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run into problems.[4] In a matter of weeks, EUR 70 billion were redeemed from these funds, predominantly by institutional investors; around 15-20 suspended redemptions for a short period, and 4 of them were definitely closed. The difficulties experienced by these funds created confusion for investors about the definition, classification and risk characteristics of MMFs. In September 2008 the financial instability arising from the Lehman Brothers' bankruptcy, the run on the Reserve Primary Fund and the meltdown of credit and money markets created new pressures for MMFs. In Europe, the difficulties were compounded by the broad extension of state-supported guarantees to bank deposits, which are the greatest competitor of MMFs in Europe.

At the time, the industry feared that redemptions could outpace investment managers' ability to raise liquidity because the market for short-term commercial paper had closed. Together with IMMFA, EFAMA discussed the situation with high-level officials from the European Central Bank (ECB) and the European Commission. At the end, the ECB decided that the broadening of the scope of eligible collateral to include certificates of deposit not traded on "regulated markets", together with the reduction in interest rates, would represent an important contribution to support short-term money markets and, therefore, MMFs. This approach proved effective, as the pressures faced by MMFs started to recede in November 2008, with the result that MMFs grew stronger in Europe in 2008.

The events of the fall 2007 convinced the MMF industry about the need to clarify what the "MMF" label should include. This prompted EFAMA and IMMFA to create a joint working group to develop a pan-European definition of MMFs. This work was completed in July 2009 with the publication of a recommendation for a European classification and definition of MMFs. In a nutshell, EFAMA and IMMFA proposed to reserve the MMF label to funds designed to generate money market like returns, while aiming at preserving capital and maintaining strong liquidity, thereby enhancing investor protection. In May 2010, CESR, the Committee of European Securities Regulators, issued guidelines which created the first common definition of European MMFs.[5] The definition is broadly in line with the industry recommendation made by EFAMA and IMMFA. It uses a two-tier approach, differentiating between "short-term MMFs" and "MMFs". Both categories include specific criteria which must be met in order for the fund to be classified as a money market fund. These criteria include restrictions on exposure to interest rate and credit risks, with general obligations imposed regarding the risk management of the fund. Among other things, these criteria imposes that "short-term MMFs" operate a very short weighted average maturity (no more

[4] The classification of enhanced MMFs varied across Europe; in France, for instance, contrary to common knowledge, they were classified by the supervisory authority (AMF) as mixed funds.

[5] See www.cesr-eu.org/popup2.php?id=6638.

than 60 days) and weighted average life (no more than 120 days), and that "MMFs" operate with a longer weighted average maturity (no more than 6 months) and weighted average life (no more than 12 months). "Short-term MMFs" can have either a stable or a floating NAV, whereas "MMFs" must have a fluctuating NAV.

The guidelines also require that both categories of MMFs draw investor attention to the difference between the money market fund and investment in a bank deposit. It should be clear, for example, that an objective to preserve capital is not a capital guarantee.

European MMFs in the Future

Total MMF assets have always been much lower in Europe than in the United States. This is largely because the European financial system is bank-dominated. As a result, bank deposit is the principal vehicle used by retail investors to manage their cash and, consequently, MMF holdings are small relative to banks' deposits.[6] In this context, MMFs in Europe are predominantly used by institutional investors, with many operating with both floating and stable NAV MMFs. Diversification of investments, same-day liquidity, segregation of assets and competitive money market returns are driving these investors' interests for MMFs. MMFs also allow corporate treasurers to outsource the analysis of credit and counterparty risks to professional cash management teams. Furthermore, by maintaining a certain level of demand for securities issued by companies, MMFs offer companies possibilities to diversify their financing from bank loans to securities. There is therefore no doubt that MMFs play an important role in providing the necessary diversification on the asset side to protect investors' capital and as a source of funding in the capital markets.

Against this background, EFAMA members strongly believe that it is essential to assess very carefully the effectiveness and adequacy of possible reforms for MMFs to avoid that their implementation results in disruptions and unintended consequences. This analysis should take on board the impact of the financial reforms launched by the G20 Leaders to create a sounder financial system and reduce system risk globally. Presumably, the new capital and liquidity standards developed by the Basel Committee on Banking Supervision and the agreed policy framework for reducing the moral hazard posed by systemically important financial institutions against the backdrop of the OTC derivatives markets reforms and the agreed principles for reducing reliance on CRA ratings and strengthened cooperation between supervisory authorities, should indeed address the failings that led to the systemic

[6] ECB monetary data show that MMF holdings for the area as a whole remain small relative to banks' retail deposits (around 8%). This includes demand deposits and time deposits. See Chapter 2 of IMF Global Financial Stability Report of October 2010.

liquidity crunch that caused strains on MMFs and the global financial system during the recent crisis.

The importance of taking a holistic framework for dealing with the systemic risks can be illustrated by referring to the Basel III proposals to strengthen liquidity buffers and lessen asset/liability maturity mismatches in banks. More specifically, these proposals include obligations for banks which have stable NAV MMFs managed somewhere within their group to hold liquid assets and stable funding against that exposure. These measures are likely to stem the buildup of vulnerabilities and mitigate the effects of possible runs on MMFs. Of course, it is crucial that the required amount of liquid assets and stable funding be appropriate and proportionate to the true risks posed by MMFs.

From this perspective, the European MMF industry is very much concerned about the knockout effects that additional regulatory measures could have on MMFs, including floating NAV funds. In particular, the extra burden put on MMFs and their sponsors might cause substantial shifts of assets from MMFs into traditional bank deposits and/or other vehicles that would be less demanding in terms of regulatory requirements than MMFs. This is already taking place in several European countries. As noted in the Report of the President's Working Group on Financial Markets, changes to MMF rules might displace or even increase systemic risks, rather than mitigate them, and make such risks more difficult to monitor and control.

In sum, whilst understanding the U.S. authorities' motivation to address MMFs' susceptibility to runs, we hope that the policy options will be reviewed within a comprehensive approach, taking into account their interactions with the global financial reforms being implemented or under discussion. In the meantime, in Europe, the MMF industry is confident that the implementation of the CESR definition of MMFs will enhance investor awareness about their exact nature and strengthen the asset quality of MMFs, thereby enhancing their resilience in crisis times.

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