IMMFA
INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

By email: baselcommittee@bis.org

Secretariat of the Basel Committee on Banking Supervision
Bank for International Standards
CH-4002
Basel
Switzerland

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Dear Sirs

International framework for liquidity risk measurement, standards and monitoring

The Institutional Money Market Funds Association (IMMFA) welcomes the opportunity to comment on the consultative document on international liquidity risk measurement, standards and monitoring.

IMMFA is the trade association which represents the European triple-A rated money market funds industry. Triple-A rated money market funds are managed according to rigid and transparent guidelines, in order to offer safety of principal, liquidity and competitive money market returns. Increasingly, these funds are used by institutional investors to manage liquidity and act as important alternatives to cash accounts. Since its inception in 2000, IMMFA's funds in Europe have grown from around €40 billion to over €425 billion (as at January 2010). Further information on the Association and triple-A rated money market funds is available on the IMMFA website, www.immfa.org.

Whilst most of the requirements in the consultative document are not in our purview, we have significant reservations about the proposals under the liquidity coverage ratio and net stable funding ratio with respect to the treatment of money market funds.

The regulatory regime that is applicable to money market funds is currently being amended in both Europe and the US. The proposed outcome will be a more restrictive regime which further limits the risk to which a money market fund may become exposed. In addition, the industry and the regulatory community are seeking to address more structural issues associated with money market funds in order to mitigate the potential for systemic risk to arise from the actions of the funds or the investors therein. The outcome of these amendments and discussions will be a significantly more robust industry which has limited potential for reputational risk to arise within a bank due to exposure to a money market fund.

Consequently, we urge the Committee to await the outcome of the amendments within the money market fund industry before determining whether there exists any potential reputational risk to a bank from exposure to a money market fund. This will be a more prudent occasion on which to assess the risks arising from money market funds.

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We would also highlight that we consider that a money market fund that only invests in government debt should be considered as a high quality liquid asset. Such funds only invest in assets that themselves will be considered as a high quality liquid asset. The fund simply constitutes a wrapper around these assets, and does not result an investor being exposed to any significant additional liquidity risk. Furthermore, during the recent financial crisis, these funds witnessed huge growth. As identified in the consultative document, this is prime evidence of the market considering the product to be robustly liquid in the most illiquid of markets. We therefore request that the proposals are amended to include government-only money market funds as a high quality liquid asset.

A further explanation of these positions is included in the following pages. We would welcome the opportunity to discuss these issues should further clarification be required.

Yours faithfully

Nathan Douglas.

Nathan Douglas
IMMFA Secretary General

IMMFA response

Contingent funding liabilities and obligations

In the consultative document, it is proposed that banks hold liquid capital to address the fact that the propensity for reputational risk to arise from exposure to certain products could result in the bank providing financial assistance.

Where the exposure relates to a constant net asset value money market fund, we consider that the proposals are unnecessary and inappropriate for the following reasons:

(a) the resilience of the product has been improved;

In both Europe and the US, actions have been proactively taken by industry participants and regulators to limit the risk which may be associated with a money market fund.

This has resulted in reductions in the amount of credit risk, liquidity risk and interest rate risk which funds may become exposed to. Additional disclosure is also being provided by the funds in order to increase the transparency of the product to the investing community. The current environment within which the funds now operate is therefore significantly more resilient than that pre-crisis.

(b) the potential for systemic risk to arise is being addressed;

We recognise that money market funds have the potential to be subject to bank-like runs due to their objectives of providing capital security and same-day liquidity. Should either one of these be exposed to a material risk of no longer being provided, investors may seek to move their investment to a more secure or liquid location. In the unlikely event of this happening, the entities which rely upon money market funds for a source of funding could be impacted, resulting in a systemic disruption.

Again however, the industry and the regulatory authorities are currently reviewing how this systemic risk may best be mitigated. Consideration is being given to the possibility of developing an industry liquidity facility as well as imposing a charge on redeeming shareholders in order to ‘pay’ for the provision of immediate liquidity.

(c) in light of these actions, the potential for reputational risk to crystallise within a bank due to exposure to a money market fund is limited further;

With both the amount of risk to which the funds may become exposed being reduced, as well as more structural change to the industry being addressed to diminish the potential for systemic risk, the propensity for these products to fail to deliver against their objectives of capital security and liquidity is severely restricted. Consequently, the likelihood of a bank becoming exposed to a level of reputational risk that would warrant intervention due to issues associated with any money market fund managed within the same financial services group should become insignificant.

We therefore do not agree with the proposals relating to money market funds within the consultative document. Given that the likely timescales for delivery of the Committee’s standards and the amendments to the money market fund industry should not be inconsistent, we would urge as a minimum that the Committee should reconsider the propensity for reputational risk to arise from money market funds only after all work in this sector has been concluded. This would result in an appropriate standard being applied which reflects the nuances of the risk.

If however the Committee is unwilling to await the outcome of the amendments to the money market funds industry that are currently being considered and implemented, we have two

observations which we strongly urge the Committee consider before the final standards are published:

1. A fully harmonised standard must apply;

   The consultative document proposes that national discretions may be utilised in order to address contingent funding liabilities. Such contingent funding liabilities may result in significant liquidity drains, which could result in the crystallisation of systemic risk on a global scale. Therefore, in order to address such systemic risk, it is a fundamental necessity that a globally harmonised standard is applied. If reliance is placed upon national discretions, the likelihood of systemic risk being averted is only as good as the lowest standard.

2. Non-contractual obligations may arise from <u>any</u> product that seeks to provide security of capital or a positive return;

   Under both the net stable funding ratio and the liquidity coverage ratio, banks would have to consider their exposure to money market funds that are marketed with the objective of maintaining a stable value. However, there are other products available which could result in similar reputational damage to a bank should they fail to deliver against their objectives.

   As well as stable value money market funds, other funds seek to provide capital security. The expectation of investors in these funds is that this will be provided in all circumstances. Should this security of capital be lost, the investor will redeem and seek to place that investment elsewhere. Given exposure to such funds, a bank could therefore be exposed to reputational damage that would warrant intervention and would impact the balance sheet of the bank.

   In addition to products that offer security of capital, any product that offers a continual positive return will have an investor base that expects that return to be consistently delivered. In the event that such a return does not materialise, investors will redeem and seek an alternative. Again, a banking entity may consider it necessary to intervene to mitigate reputational risk[1].

High quality liquid assets

The consultative document proposes that institutions hold a stock of unencumbered, high quality liquid assets. We consider that triple-A rated government-only money market funds should be considered as a high quality liquid asset and propose that institutions are permitted to include investment in such funds within their stock of liquid assets. We outline below why we consider that the final standards on international liquidity management should permit the inclusion of these funds as a high quality liquid asset.

(a) Investment is only in high quality liquid assets

   A money market fund seeks to provide security of capital and same day liquidity by investing in high quality short-term debt instruments. Some money market funds limit risk further by investing only in government debt (hereafter referred to government-only money market funds). Such debt would all fall within the proposed definition of a high quality liquid asset under the proposals.

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[1] This is recognised by the Banque de France in their recent paper 'Synthèse de l'évaluation des risques du système financier français'.

(b) There is limited liquidity risk arising from investing in a fund

A fund is simply a wrapper around the underlying instruments. An investor in a collective investment scheme has a legal entitlement to a proportion of the underlying assets (the proportion is consistent with the size of his investment relative to the total size of the fund). Therefore, the investment would be unencumbered.

Whilst the funds operate a cut-off time by which redemption requests must be submitted in order to receive cash on that day, these times simply allow for the settlement period which must operate and are akin to the times by which redemption requests must be submitted where government debt is directly purchased.

The prospectus of an IMMFA money market fund will include a requirement that the fund provides same day liquidity to investors. The liquidity risk associated with a government-only money market fund is not therefore dissimilar to that associated with the proposed range of high quality liquid assets.

(c) The funds received large inflows during the financial crisis

The consultative document states that the market characteristics of high quality liquid assets should include a flight to quality in times of systemic crisis. During the immediate four weeks following the Lehman bankruptcy, the triple-A rated government-only money market funds within the IMMFA membership received inflows of almost €50 billion, representing growth of 94%. At a time when liquidity in markets had generally disappeared, this is a clear indicator of a flight to quality and the comfort with which investors view the product.

(d) There is limited risk of loss

A money market fund seeks to provide capital security at all times. In order to achieve this objective, the funds represented by IMMFA implement a number of risk limiting factors which include the requirements to achieve and maintain a triple-A rating, a maximum weighted average maturity (WAM) and a weighted average life (WAL) and minimum levels of overnight and one week liquidity. Additionally, a government-only money market fund will only invest in government debt, therefore the risk of loss is equivalent to direct investment in government debt.

The risk of loss of value within a triple-A rated government-only money market fund is therefore extremely low, commensurate with the high quality liquid assets which are currently permissible.

On the basis therefore that there is limited liquidity risk arising from investing in a fund (as compared with direct investment in government debt), that the funds provide same day liquidity, have limited risk of loss and have witnessed large inflows during the recent financial crisis, we consider that triple-A rated government-only money market funds should be considered to be a high quality liquid asset. Consequently, we urge the Committee to amend the proposals to specifically recognise government-only money market funds for liquidity management purposes.

Our view is supported by the recently revised FSA liquidity regime in the UK. The revisions to this regime that were introduced in December 2009 permit certain institutions to use specific money market funds for liquidity purposes.