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Dear Patrice

IOSCO working group on money market funds

Thank you for the opportunity to present evidence to the IOSCO working group on money market funds (MMFs).

We look forward to responding to IOSCO's forthcoming consultation. In the meantime, we thought it would be helpful to write a brief summary of our views:

1. MMFs make a valuable contribution to the management of short-term liquidity

MMFs provide a simple but valuable intermediation service between lenders and borrowers in the short-term debt markets. MMFs are an investment product, offering access to credit expertise, liquidity management and secure and efficient operational processes that would be prohibitively expensive to most cash investors outside of the pooled-fund environment. MMFs provide borrowers with access to short-dated securities in aggregated amounts, facilitating the management of their cash needs. These activities are carried out within a transparent, rule-governed and highly regulated environment. The growth of the MMF industry over the past 40 years is palpable testament to the willingness of a large number and diverse range of investors to pay for professional and specialised investment services for the management of their cash assets.

2. MMFs did not cause the financial crisis, but were caught up in it

MMFs did not cause the financial crisis. Rather, and as is well documented, an extended period of easy credit caused the financial system as a whole to become over-leveraged, culminating in series of headline events in September 2008, and a crisis of confidence in the financial system in general, and the banking system in particular (including: the US Government's receivership of

Fannie Mae and Freddie Mac; the sudden purchase of Merrill Lynch by Bank of America Corporation; the bankruptcy of Lehman Brothers; the emergency funding of American International Group by the Federal Reserve; and so on.)

That crisis of confidence caused investors to reduce/refocus their exposure to the banking system. For example, in the US, investors 'switched' their exposure from prime MMFs (which hold deposits and securities issued by the banks and other short-term issuers) to government and treasury MMFs. Needless to say, it is unusual and systemically consequential for investors to lose confidence in the banking system as an asset class; but redemptions from prime MMF were an effect, rather than a cause, of that loss of confidence. In a 'world without MMFs', investors would still have sought to reduce their exposure to the banking system and increase their exposure to government and treasury – and potentially in greater numbers.

3. The financial crisis highlighted the importance of liquidity risk management

The financial crisis resulted in a significant withdrawal of liquidity from secondary money markets. That presented a challenge to MMFs seeking to sell assets in order to raise cash to meet redemption payments and highlighted the importance of liquidity risk management.

We therefore support reforms that will enable MMFs to manage liquidity risk, including:

- Managing liquidity risk through 'natural' liquidity rather than through secondary markets. For example, reforms that require minimum amounts of a MMF's portfolio to mature within, say, one and five business days.
- Managing liquidity risk by requiring MMFs to know their clients/client types, monitor subscription/redemption cycles, and manage shareholder concentration. (Such measures may need to be accompanied by requirements on distributing intermediaries to disclose the identity of underlying investors to managers of MMFs.)

4. MMFs are not 'shadow banks'

The Financial Stability Board defines the shadow banking system as: 'a system of credit intermediation that involves entities and activities outside the regular banking system, and raises i) systemic concerns, in particular by maturity/liquidity transformation, leverage and flawed credit risk transfer, and/or ii) regulatory arbitrage concerns.'

We do not believe that MMFs fit this definition:

- *MMFs and maturity/liquidity transformation*
Both banks and other participants in the capital markets provide maturity and liquidity transformation services, and it is important for policy makers to identify, understand, and articulate how financial intermediaries provide these services when assessing the inherent risk of an activity. MMFs perform liquidity transformation, insofar as investors' subscriptions are invested at term, but their redemptions must be met same- or next-day. However, the liquidity transformation performed by MMFs is an order of magnitude less than that performed by banks, and is subject to tight controls. For example maximum residual maturity per instrument and weighted average life and maturity are strictly limited by regulation.
- *MMFs and leverage*
MMFs are classic 'long only' investment funds, and do not employ leverage as part of their investment strategy. (Some funds are permitted to temporarily borrow in order to meet redemption payments.)
- *MMFs and flawed credit risk transfer*
The FSB report says: "Authorities should monitor the off-balance sheet exposures (e.g. guarantees, commitments, credit derivatives, and liquidity puts) provided by financial institutions and entities that constitute part of a credit intermediation chain. When monitoring off-balance sheet exposures, authorities should bear in mind that some entities may provide implicit support to other entities."

MMFs are investment products. Their prospectuses provide a clear description of the risks and rewards attributable to investors, and create no expectation of explicit or implicit underwriting of those risks by the fund manager.

- *MMFs and regulatory arbitrage*
Some commentators have argued that MMFs were created to arbitrage regulation, and therefore, understandably, they recommend MMFs should be prevented from continuing such arbitrage.

For example, some have argued that US MMFs evolved to circumvent Regulation Q (a depression-era regulation that placed a limit on the payment of deposit interest). However: Regulation Q was in force for many decades before US MMFs evolved. Furthermore, U.S. MMFs have continued to flourish despite the progressive repeal of Regulation Q, and the Dodd-Frank Act's effective repeal of the prohibition of paying interest on business checking accounts in the US. MMFs have grown outside of the US where there is no equivalent of Regulation Q. It therefore follows that Regulation Q is neither a necessary nor sufficient explanation for the existence of MMFs.

Allegations of regulatory arbitrage, and the very expression 'shadow banking', suggest that MMFs are unregulated, or less well regulated than banks. In fact, MMFs are subject to more prescriptive restrictions on their portfolio holdings than are banks, and are one of the most tightly regulated types of mutual fund. In the US, MMFs are regulated by rule 2a-7 under the Investment Company Act of 1940, and in the EU, MMFs are regulated as UCITS, subject to the restrictions set forth in the Eligible Assets Directive and the ESMA Guidelines on a common definition on European Money Market Funds. Those various regulations impose restrictions on MMFs' investment and borrowing powers, and requirements on disclosure to investors, that distinguish MMFs from the other institutions and products being considered by the FSB.

5. Other observations

It has been proposed that MMF managers should be required to hold additional capital to offset their funds' potential credit losses. We disagree with this proposal. MMFs are investment products, whose risks and rewards are borne by their investors. Requiring MMF managers to back-stop losses, and to provision for those losses through a capital requirement, would fundamentally undermine the economic viability of MMFs, by converting them from an investment product into a *de facto* banking product.

It has been proposed that MMFs should be required to adopt a fully floating price. We disagree with this proposal. The pricing mechanism of MMFs was not the cause of the financial crisis.

6. Conclusion

MMFs did not cause the financial crisis, but were directly impacted by it. That impact demonstrated the importance of liquidity risk management. Reform of MMFs should therefore focus on the fund's internal liquidity risk, including by requiring them to maintain 'natural' liquidity (for example, by stipulating that minimum amounts of their portfolio should mature within one and within five business days) and to know their clients/manage shareholder concentration.

Some regulators, such as the SEC, have already imposed reforms to that effect; and those reforms were tested this past summer when U.S. money market funds met, without incident, large volumes of shareholder redemptions during periods of significant market turmoil, including the historic downgrade of U.S. government debt.

Yours sincerely

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