TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

The Association of Corporate Treasurers

Comments in response to
Money Market Fund Systemic Risk Analysis and Reform Options
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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine* and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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Our members work widely in companies of all sizes through industry, commerce and professional service firms. The companies in which they work will often have surplus cash which needs to be invested relatively short term. Because of the liquidity and, most importantly, the (relatively) diversified portfolio characteristics of Money Market Funds (MMFs) these are a popular form of investment for non-financial companies. Accordingly we make comments from the standpoint of large scale corporate users of MMFs.

Generally speaking because of the need for liquidity and a lack of price volatility in their cash investments companies tend to invest in bank deposits and CDs, short term government paper, MMFs and, perhaps less commonly, in short term commercial paper or notes. Even where the company circumstances mean that cash can be invested slightly longer term, MMFs remain useful for liquidity management. The existing structures available from the MMF sector have proved a convenient and useful instrument for companies.

As in many areas of financial regulation initiatives to make the financial system in some sense safer can have the effect of passing risk back to customers or other parts of the financial system. In the case of reforms to the MMF sector one test should be to work through the potential knock on effects to users of MMFs and review the balance between a safer MMF sector against reduced utility for the users and the risk that users will be forced to change how they invest short term cash in a way that throws more risk onto them. (For example if, for whatever reason, MMFs become a less attractive product, companies may instead place deposits direct with financial institutions and thus lose the diversification benefit and be exposed to more concentrated credit risks to small number of individual counterparties.]

The conclusion we reach is that MMFs in their current forms should be permitted to continue to exist and that the various options to create capital buffers are not really needed. The ability to impose certain liquidity controls over redemptions in an emergency may help restore stability in a crisis and are worthy of further consideration.

Ultimately investors themselves have a responsibility to inform themselves about what they are investing in and should be capable of deciding for themselves if they are suitable. To do this of course they do need sufficient clarity of information about the structure of the funds they invest in, their investment policies and the actual portfolios held. We would encourage funds to provide wider sectoral diversification of their investments perhaps through requirements for good disclosure of investments by sector and by country.

We note that few CNAV funds invest outside the sovereign or financial services sector. Some funds may have a small amount of non-financial corporate paper, but companies find it hard to invest away from the sovereign or financial sector with the same “ready-made” diversification as MMFs offer in those sectors.

Response to specific questions

We refrain from replying to all the questions, concentrating on those most relevant to non financial investors. On certain questions others are better placed to respond than we are.

Question 1*: Do you agree with the proposed definition of money market funds? Does this definition delimit an appropriate scope of funds to be potentially subject to the regulatory reform that the FSB could require to put in place, with an objective to avoid circumvention and regulatory arbitrage?*

A1: We note that the sorts of MMFs that are being covered by your consultation are intended to be those presented as cash or liquidity funds.

It is unfortunate that the sorts of MMF that invest slightly longer term, seek higher yield and that do not offer same day liquidity are still known as Money market funds, although sometimes with an additional qualifier as in “MMF plus” or “enhanced MMF”. Smaller companies are often surprised that they are in higher risk investments than they intended. More clarity in nomenclature is desirable.

***Question 2**: Do you agree with the description of money market funds' susceptibility to runs? What do you see as the main reasons for this susceptibility?*

A2: We accept that MMFs could be susceptible to runs. They offer instant liquidity and therefore in practical terms could be subject to a run. They do attract a very risk averse type of investor and indeed the concept of a CNAV fund could mean that any hint of "breaking the buck" could act as a trigger. As explained in Q 12 we do not regard that as sufficient justification for a ban on CNAV funds

***Question 3**: Do you agree with the description of the role of money market funds in short-term money markets? To what extent this role may create risks for short-term funding markets and their participants? Are there changes to be taken into account since the 2007-2008 experience? What are the interdependencies between banks and MMFs and the risks that are associated?*

A.3: We are sympathetic to the picture you paint. Most non-financial companies investing in MMFs (except, of course, for segregated funds run by a manager for the corporate only) set a maximum to the company's proportion of the total fund and pay attention to the granularity of other investors' holdings. However, the greater correlation between banks' policies and attitudes, can mean that large holdings by banks as a class can exacerbate the features you are concerned about.

Given that non-financial companies usually give priority to security over yield, it is not surprising that MMFs seeking to attract them are conservative investors. It is not a criticism of MMFs that they avoid an asset class at times of stress for that class, as seen with European banks in the current crisis. It is unlikely that investments made directly rather than through an MMF would go materially to the assets being avoided by the MMFs.

***Question 4**: What is the importance of sponsor support for MMFs? What is the respective percentage of bank versus non-bank sponsors in the MMF industry? Are there differences among MMFs depending on their sponsors? What are the potential systemic risks of support or protection against losses provided by sponsors?*

A4: For some corporate investors in MMFs the concept of some possible sponsor support has been influential in their choice of fund, even though these companies have always recognised that there is no legal obligation. In recent years the perception that there might be some implied sponsor support has declined and now does not feature particularly highly in the minds of investors. Name recognition and the reputation of the sponsor do count to a lesser extent toward the expectation that a given fund should be well run.

***Question 5**: Do you agree with the description of MMF benefits? Are there other benefits of MMFs for investors than those outlined in this presentation? What are the alternatives to MMFs for investors? How has investor demand for MMFs recently evolved? What would lead investors to move away from MMFs to other financial products?*

A 5: We agree with your description of the benefits of MMFs. Our perception is that more and more companies are making use of this form of investment, normally as a preferred alternative to direct bank deposits. With the credit ratings of banks now much lower than in the past, company treasurers are seeking reduced credit risk. The diversification of credit risk that can be achieved through a fund is a big selling point, particularly for those with smaller amounts to invest where creating your own diversification would reduce individual deposits to non-dealable sizes.

Companies continue to value the same day liquidity even though for many companies this is not strictly needed other than for a small amount of genuine day to day working capital needs. The degree of conservatism seen in that most corporate investments of cash are overnight, reveals a high preference with liquidity though perhaps a steeper short-term yield curve might eventually tempt some investors out to week fixed or 30 days. Given the high concentration of MMF investments in the financial sector, confidence in financial stability would probably need to be established first, however.

Question 6*: Do you agree with the proposed framework comparing money market funds and bank deposits? Are there other aspects to consider?*

A6: We agree with your comments about the similarities between MMF investments and bank deposits, but there are also big differences only some of which you mention. The maturity transformation by funds is quite modest given the low WAM / WAL of funds and they generally do not employ gearing. The investments they make are in a very specific asset class with very specific and frequent disclosures already being made. They are single purpose entities with their policies clearly visible. (The attitude of non-financial corporates to liquidity/maturity is seen in our answer to 5, above).

Question 7*: Are there other similarities or differences between CNAV and VNAV funds which would be useful for the analysis? Is there evidence (based on representative samples) showing differences in the fluctuation of the funds' NAV depending on their model? What is the extent of the use of amortized cost accounting by VNAV funds? Has this practice evolved over time?*

A7: Some VNAV funds may appear to have very different characteristics to CNAV funds, but this is possibly misleading since many VNAV funds are investing much longer term and with notice periods for redemption. In other words, they are not liquidity funds at all. Others are better placed to answer the more technical parts of the question.

Question 8*: What is the importance of ratings in the MMF industry? What is the impact of the monitoring function of credit rating agencies for MMFs? What are the potential systemic risks associated with ratings in the MMF industry?*

A8: From the point of view of a corporate investor the credit rating of a MMF is vitally important. Non-financial corporates are not in business to make money from money. Investing is very much an ancillary activity and one of the advantages of investing in MMFs is to outsource the credit appraisal process and creation of portfolio diversification. What remains is to assess the credit standing of the fund as a whole and to that end the credit rating grade of the fund is crucial. In addition treasurers take comfort from the ongoing review process of the rating agencies which is almost like having a regular compliance audit performed on the funds' investments. Treasurers do also like to review the portfolio make up for themselves. This can be important if the company has credit exposures to specific banks, perhaps through derivatives, and wants to avoid undue concentration.

In many ways the rating agencies act as regulators and supervisors of the MMFs. This is socially very valuable.

We suspect that the AAA standing of many funds is not always fully understood and is assumed to mean the same as a AAA long term debt rating. The agencies have been very careful to add a suffix to their fund ratings (e.g. Aaa-mf) to distinguish the ratings but not all users will appreciate this. As often, there is an important educational effort needed to ensure that more market participants (and potential ones too) understand market features.

Question 9*: Are existing rules adequately addressing risks regarding the management of collateral from money market funds? What are the risk management processes currently in place with regard to repo and securities lending transactions? Do MMFs present unique issues with regard to their use of repo markets or would general policy recommendations that the FSB may issue regarding repo markets be applicable?*

We give no answer to this question.

Question 10*: Are the above-mentioned changes in the environment of MMFs relevant factors to take into consideration? What are some of the implications for regulatory options? Are there other aspects to consider?*

We give no answer to this question.

Question 11*: Do you agree with the systemic risk analysis and the rationale for reform presented in this section? Are there other factors to consider?*

A 11: In considering policy options there would appear to be a concentration on financial stability and market functioning. Clearly these are important to users but there is a danger of thinking only about the regulated sector itself. Changes to financial services providers affect users in the non financial sector or what we call the "real economy". The wider implications for the real economy must also be taken into account including the transferring of risk or inefficiencies or costs between it and the financial sector.

Question 12*: Do you agree with the benefits of imposing a mandatory move from CNAV to VNAV, which would amount to prohibiting the use of amortized cost valuation for any securities held by a MMF? Are the challenges identified in the US context valid in other jurisdictions currently authorizing CNAV funds? How could these challenges be overcome?*

A12: We do have some discomfort in the presentation of funds as CNAV to the extent that the terminology seems to emphasise the constant value element and imply that in some sense the return of principal is guaranteed, when in reality, like any investment, there is a degree of credit risk, and price risk as market interest rates change. However this is no different in concept to a bank deposit for a fixed term where the principal is presented as the amount you will get back but in reality a credit risk exists on that too (not mitigated for wholesale deposits by deposit insurance), along with an opportunity cost if rates change.

We take the point that amortised cost accounting holds out the perception that there is no price risk on a CNAV fund so that in a crisis if the value does come under pressure it could contribute to instability and a run whereas within VNAV there is a form of pressure release through the price. However, in practice, the difference is small and as you yourself say, even VNAV would not prevent a run.

The big difference arises from the different investment policies and it is unfortunate that the term MMF is used across the market rather than confined to (currently CNAV) liquidity funds.

On balance, we conclude that although the CNAV terminology could be deemed slightly misleading there is no necessity to prohibit such funds. Better to stop non-liquidity funds calling themselves MMFs.

Question 13*: What would be the main effects of establishing a NAV-buffer? What would be the most practical ways to implement such buffers? Should various forms of NAV-buffers be allowed or should regulators favor a single option? What would be a realistic size of the NAV-buffer and what would be the impact in terms of costs for running MMFs? In the case of subordinated shares, could the option be seen as creating a securitization position, with associated requirements in terms of retention?*
Question 14*: Do you agree with the description of the challenges associated with the establishment of a private insurance? Are there ways to address them?*
Question 15*: Do you agree with the description of the challenges and potential second-round effects of a conversion of MMFs into special purpose banks? Are there ways to circumvent those effects?*
Question 16*: What are the main advantages and drawbacks of two-tier system(s)? Would it be sufficient to address the risks identified? What could be the conditions applicable to CNAV funds? What could be the potential impact on investor demand? Should certain funds be exempted from certain risk limiting conditions due to their holdings?*
Question 17*: Do you agree with the suggestion that reserving CNAV funds for only certain investors (i.e. retail or institutional investors) would face practical challenges and would not be sufficient to address the risks identified?*
Question 18*: Regarding the different structural alternatives described in Section 1, what are the benefits and drawbacks of the different options described above? How could they be prioritized? What are the necessary conditions for their implementation?*

A13 -18: Your paper raises some interesting ideas to create various forms of buffers to protect investors and market stability. However, since the ACT regard the existing structures as working and providing a useful diversification instrument for investors, we see no necessity to invent a new type of instrument. [Of course were such instruments to be created to supplement the existing forms we would welcome the additional flexibility offered to investors. It would be interesting to see what demand for these sorts of funds would build up.]

Question 19*: What are the main benefits and drawbacks of imposing the use of marked-to-market accounting for all the instruments held by MMFs? What is the availability of market prices for securities commonly held by money market funds? Are there situations where this general principle could not be applied?*

We give no answer to this question.

Question 20*: Should the use of amortized cost accounting be limited, and, if so, how? Are general restrictions on funds' WAM or WAL preferable? Are there practical impediments (e.g. availability of prices) to imposing stricter requirements on the use of amortized cost accounting than current existing regimes? What would be the potential effects on MMFs' investment allocation and short-term funding markets? What monitoring should be implemented? What conditions are advisable? In particular, please* *describe the rationale, feasibility and effects of limiting the residual maturity of instruments to [30-60-90-other] days. What materiality threshold could be proposed?*

A20: The use of amortised cost accounting does need to be subject to some limits be they by reference to maturity or to the deviation of shadow prices. Other will be in a better position to judge this than we are.

Question 21*: What are the main benefits and drawbacks of imposing global liquidity restrictions? Should there be restrictions regarding (daily/weekly) liquid assets as well as regarding illiquid assets? Are global definitions of (daily, weekly) liquid and illiquid assets practical? Are there other conditions to consider (e.g. regarding the concentration of assets)?*

A21: We regard the requirement for certain liquidity standards as a crucial element of regulation or the definition of liquidity funds. We have not performed any analysis as to what liquidity rules are optimal but we do accept that the tightening of liquidity standards in 2010 were reasonable, even helpful. (10% overnight and 30%< 1 week in the US and 10% overnight and 20%<1week for IMMFA funds, plus in each case certain maturity limits).

Although rules exist to limit concentration in a single name or group and in illiquid assets we are not aware of limitations for industry sectors or countries. In terms of contagion or a breakdown causing increased correlation between obligors in the same industry sector a diversification by industry sector or geography could help reduce risk. However stipulating specific sector allocations would be to change the very nature of MMFs and remove investor choice. To some extent investors can already make this sort of sector analysis themselves from the disclosures made by funds, but perhaps some industry-agreed uniform definitions of sectors might be helpful plus some encouragement for funds to provide this sort of asset breakdown.

Question 22*: To what extent are managers able to "know their customers" and anticipate redemptions? Are there practical obstacles for managers to "know their customers" (e.g., in the case of platforms, omnibus accounts) and how could they be addressed? What are the main features of the funds' investor base to take into consideration from a liquidity risk management point of view? Should conditions, e.g., regarding the concentration of the investor base be considered? Would this requirement allow fund managers to better understand and manage the risks to which the fund is exposed?*

A22: In planning maturity profiles it must be helpful for fund managers to "know their shareholders", indeed we had rather assumed that this would be a normal part of good management of any fund (especially funds subject to redemption), irrespective of regulation. We would have no objection to setting concentration limits on investor bases. In fact we know that many corporate investors include within their own investment policies some form of concentration limits such as stipulating that the company's investment should not represent more than 10% of the assets in the fund, or the like.

Question 23*: Would such a liquidity fee generate a pre-emptive run? If so, when and are there ways that pre-emptive run risk could be reduced? How would shareholders react to the liquidity fee? Would it cause shareholders to transfer their MMF investments to alternative investment products? If so, which types of shareholders are most likely to make such transfers and to which products and will such a shift in investment create new* *systemic risks or economic, competitive, or efficiency benefits or harm? Would MMF board directors be able to impose a liquidity restriction despite potential unpopularity with investors and competitive disadvantage imposed on the fund? At what level such a liquidity trigger should be set?*

***Question 24**: How would shareholders react to a minimum balance requirement? Would it cause shareholders to transfer their MMF investments to alternative investment products? If so, which types of shareholders are most likely to make such transfers and to which products and will such a shift in investment create new systemic risks or economic, competitive, or efficiency benefits or harm?*

***Question 25**: What are the benefits of using bid price for valuing the funds? Are there other options (such as anti-dilution levy) which could be explored to reduce shareholders' incentive to redeem?*

***Question 26**: What are the benefits and drawbacks of allowing redemptions-in-kind? Are there practical impediments to implementing this option (e.g. some portfolio securities cannot easily be divided)?*

***Question 27**: What are the benefits and drawbacks of requiring gates in some circumstances? Which situations should trigger gates to be imposed to redeeming investors? Would it be enough to permit gates in some jurisdictions? Would there be a risk of regulatory arbitrage?*

***Question 28**: Do you agree with the suggestion that the establishment of a private liquidity facility faces challenges that make the option unworkable or do you see ways to circumvent these challenges?*

A23-28: Your report considers various controls over liquidity so that in emergency circumstances a fund might impose redemption restrictions, redemption fees, or redemptions in kind. None of these sorts of measures are particularly welcome but in a crisis they may be helpful in restoring some order and fairness between investors. Since in the normal course of affairs these would not impact the characteristics of the fund (in the way buffers would) we accept that there could be some merit in them. Requiring a liquidity facility to be held by the fund on the other hand would be impracticably costly and, unless very substantial in size (when it would be even more costly) of limited value. We do not support this sort of measure.

***Question 29**: What are the main benefits and drawbacks of the provisions included in current regimes referring to external CRA ratings? Are there alternatives to credit ratings that reasonably can be substituted?*

A.29: We note that the independently provided external ratings give a measure of assurance to investors, rather than relying only on the managers' judgements, but otherwise give no answer to this question.

***Question 30**: What are the benefits of MMF ratings? Should a greater differentiation between MMF ratings be encouraged? To what extent are investors restricted in their investments to 'Triple-A' rated funds? What alternatives could there be (e.g. from other third parties)? What initiatives could be proposed to educate investors about MMF ratings?*

A30: Please refer to Q8 which largely covers the same issue. We accept your point that the preponderance of AAA ratings lacks differentiation between funds. This matter does warrant further analysis and debate. However, in most, and especially current, market conditions the attraction of funds rated below this except for speculative investors seem hard to understand.

Question 31*: In addition to the options explored in the four sections above, do you see other areas to consider which could contribute to reinforcing the robustness of MMFs?*
Question 32*: Do differences between jurisdictions require different policy approaches or would a global solution be preferable, notably to ensure a global level playing field?*

We give no answer to these questions.

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