FINANCIAL SERVICES BOARD (FSB) COMMENT ON IOSCO CONSULTATION REPORT: MONEY MARKET FUND SYSTEMIC RISK ANALYSIS AND REFORM OPTIONS

In providing comment as invited, the understanding of the FSB is that a high level comment on the position of the FSB is being sought, which will also highlight the FSB's main concerns pertaining the current use of money market funds. Further, that responses are sought to the specific questions raised.

The following are the FSB's comments and responses to the questions.

HIGH LEVEL COMMENT

These comments are provided primarily from the standpoint of a money market fund as a collective investment scheme.

The concerns related to systemic risks pertaining to money market funds, are mainly related to two main aspects that could lead to systemic failures, namely the 1) lack of liquidity and 2) the potential large size of 'pay-outs' on redemptions.

Within the banking environment, these problems are generally addressed by retention of capital to meet any high demand of immediate pay-outs.

However, the business of a CIS and a bank, even from a systemic risk perspective, should not be confused.

A CIS manager is in essence an administrator with a reasonably small capitalisation, although most hold sufficient operating capital to meet normal demands. A requirement for the CIS manager to hold additional capital is not a viable option. A CIS manager is not a borrower of funds as is the case with banks.

A CIS invests in instruments issued by banks, whilst banks very seldom invest in the shares/ participatory interests of money market funds. An investment in a bank's issues is mainly an investment in its balance sheet or liquidity mechanisms and is therefore carried by the bank as a liability whereas an investment in money market fund is an ownership in underlying assets – the manager or fund does not carry any liability beyond liquidation of the underlying assets and settlement.

The next consideration is for additional capital to be held in a money market fund. This requirement indicates a misconception of the technical nature of a CIS fund. A CIS fund is purely a vessel for funds received from investors, therefore implying that any and all investors can demand their funds invested in the CIS plus earnings or less market losses – accordingly, there is no 'additional' capital to be sourced from profits or other business sources as is the case with banks.

In terms of the majority of current legislation, money market funds have to be managed on a basis requiring a reasonable averaged short term to maturity, thereby providing reasonable liquidity. Coupled with this, CIS's have their own rules to meet redemption demands in a situation where there is a lack of liquidity – this normally relates to a permitted delay in settlement of redemptions, ranging from 14 days to 40 days. In the final instance, in many jurisdictional cases, actual scrip can be offered to the investor (something a bank cannot do).

Furthermore, where money market funds invest in instruments issued by the banks, the capital retention requirements already overlay the issuers of the money market instruments and should not be duplicated in the money market fund.

This leads us to conclude that the only real problem may relate to those issuers of money market instruments for which there are no existing capital requirements. The UCITS guidelines require that a money market fund may not invest in a money market instrument that is not issued by an institution with at least a capital of €10 000 000 or guaranteed by an institution with a capital of €10 000 000. This should suffice to address the risk of exposure to the issuers that are not banks with their capital retention requirements.

Accordingly, we believe that the solution lies in moving money market funds back to a pure money market CIS product that may only invest in truly liquid instruments rather than the provision of additional capital within a money market fund. As an *investment* medium, investors will need to be subjected to contractual limitations that would allow the manager to manage large redemptions over a period of time.

Money market funds have in recent times migrated in their purpose from their original concept and are now viewed as a source of funds – from a funding perspective, the value of money market funds to institutions seeking funding has been realised. This was never the original purpose for a money market fund – that purpose was to provide an *investment medium* for investors where better rates could be obtained than normal bank deposits via bulk asset purchase and added efficiencies. This shift in focus is partially to blame for the incorrect application of money market funds as a funding mechanism. Accordingly, regulators should move their focus back to the investment side of the product and thus the investors. Money market fund should accordingly be focussed back to money market instruments with a lower risk i.e. inclusive of liquidity and low risk of failure to repay, etc. (permissible assets).

It is to a large extent the perception of investors in money market funds that needs to be changed. Investors need to realise that investment in a money market funds are not equal to deposits with immediate liquidity. A money market fund remains a term-based investment.

Other fixed interest funds are more appropriate for less liquid instruments and longer term funding. Money market funds seek to focus on the short term with 60 to 90 days average maturities as

regulated. Other instruments seeking to enter the money market fund sector are often instruments that convert longer term funding instruments to fit the description of short term funding, thereby creating a mismatch of liquidity.

Returning to the issue of a constant NAV *versus* a variable NAV (marking to market), it should be noted that it is not the price of share/participatory interest that is the issue at hand. The price can be either a constant or a daily marked to market price ***provided that*** the assets are actually marked to market daily and the value of the share/participatory interest reflects this value. In other words, where a constant price is used, the daily return must reflect the daily movement in the value of the assets, which could imply a reduction of the constant price where the return is a loss sizeable enough to diminish the "capital" value of the share/participatory interest.

The effect of a pure constant NAV (without daily return accounted and reflected) would be to conceal any market fluctuation signals that may arise from valuation decreases.

It is agreed that reliance on credit ratings has proved to be an inappropriate basis for investment by money market funds. As such regulated limits and prohibitions to protect investors and stronger internal credit risk assessment practices should be established.

RESPONSES TO THE QUESTIONS RAISED

Question 1: The definition is acceptable save for the perception that a money market fund would always provide daily liquidity under all circumstances. A money market fund is not a cash fund. This is where the difference lies between a money market fund which is a collective investment scheme and a money market account which is essentially a bank deposit. It is not possible for a product, on one hand, to be managed at an average term to maturity of 60 to 90 days and at the same time provide for many different maturity dates so as to ensure daily liquidity **and** to provide a better return than any product with actual daily liquidity. Investors need to be educated about this fact to change perceptions.

Question 2: The susceptibility of runs on money market funds is not a by virtue of the product itself. When runs occur, they occur because of market perceptions (whether correct or incorrect). Runs may occur on specific shares or on the share market – does this make shares "susceptible" to runs? A CIS fund is merely a vessel for collective ownership in underlying assets. A run on money market funds could just as easily mean a run on income type funds or a run on equity type funds. Is the one type fund more susceptible to runs than another? We do not believe money market funds should be viewed differently in this regard, because of the impact that a run on money market funds could have. Investors need to be educated that where there is a run on money market funds, once the liquid assets are "used up" remaining investors would be subject to the liquidity risk of the remaining assets.

Question 3: As described in the High Level Comment above, the CIS industry needs to move away from the focus on money market funds as a funding mechanism and re-focus them as a medium for investors who wish to pool investments in the money market. The rules that ensure a larger weighting to short term funding should remain in place. The investments should be re-focussed to the highest quality paper.

Money market funds do not necessarily create risks for short-term funding – it is more likely to be the desire of issuers to issue short term money market instruments for funding without considering all impacting factors properly that creates the risks. The issuers chase the money market funds for funding – not the converse.

Question 4: In our experience, the largest money market funds are held within bank sponsors. The other large funds have insurance company sponsors. Large reputable banks and insurance companies have the benefit that their compliance processes and systems are aimed at avoiding reputational risk and accordingly more resources are directed to the proper management and compliance of money market funds. This would imply that large sponsors would be prepared to fund losses (e.g. due to settlements on incorrect prices) to some extent.

However, on the negative side, in the larger banking groups, money market instruments issued by their own banks would be favoured. Further, the impact of errors within large funds is also greater. Therefore, the systemic risk in the large bank/insurance company sponsored funds is also larger.

Question 5: The FSB has no additional comment, other than to observe that the only basis upon which investors would move away from MMF's is where the alternative product provides a better return for the same level of risk and liquidity. We believe that there is a considerable number of investors in money market funds that actually seek a slightly higher return at a slightly higher risk (low risk income funds).

Question 6: In a less sophisticated investor market (where South Africa may be included), one cannot refer to a comparison between a money market fund and bank deposit if the Constant price is removed. The maturity or liquidity mismatch is one of the main aspects that need to be regulated tightly to ensure low liquidity risk. It needs to be considered that perhaps there should be a split between those MMF's that are used by corporates as a transaction account (short term and high liquidity) and those mainly used by retail investors as an actual low risk investment.

Reference to CISs in the IOSCO documents often refer to shareholding. We appreciate the company form of many CIS's in Europe and worldwide. However, it needs to be considered that in many jurisdictions the trust form is still preferred where an investor has a participatory interest that defers a real ownership right of the underlying assets to the investor.

Question 7: See comments in our High level Comment above and question 6. We re-iterate that CNAV is not an issue per se, other than possibly for the "cliff event" as a CNAV can be maintained at marking to market with a disclosed varying daily yield, however small it is or projected to annual return.

Question 8: It is agreed that ratings should not be the main reference for selection of assets for a MMF, however, ratings will always remain valuable in evaluating the risk and acceptability of an instrument. It is imperative that rating agencies be regulated more strictly.

The choice as to whether a MMF itself is rated or not is very much a corporate competitiveness consideration and schemes should be permitted to decide for themselves whether they wish to have a rating, subject to warning to investors that the rating may change from time to time and on what basis it may change.

Question 9: Existing rules pertaining to repo markets/transactions probably do not adequately address the risks regarding the management of collateral from MMF's. In South Africa MMF's are currently the holders of collateral and do not initiate the repo. MMF's present unique issues with regard to their use of repo markets, e.g. sufficient margining of collateral, needs to be ensured.

Question 10: The changes mentioned changes in the environment of MMF's are relevant factors. The short term funding for banks off their balance sheets creates considerable pressure on MMF's to invest in structured products that are not ideal for MMF's and their typical client base.

Normal market forces such as low interest rates should not be addressed in a synthetic manner.

Question 11: We do not fully agree with the presented systemic risk analysis and we refer to our "High Level Comment" at the beginning of this document.

Question 12: We do not necessarily believe that the problem lies with a constant price and a constant price may be preferable in certain jurisdictions for investors that view a MMF as an investment competing directly with banking deposits etc. and need to compare like with like. The problem lies with reflecting the value of a unit/share correctly (marking to market) on a frequent (daily?) basis. Therefore, a constant price can be used together with a daily yield.

See "High Level Comment" at the beginning of this document.

Question 13: A NAV buffer is not supported. A MMF is an <u>investment product</u> into instruments where appropriate capital must be held.

See "High Level Comment" at the beginning of this document.

Question 14: Private insurance would be a very relevant expense to either the CIS Company or the investors through the scheme, which is prohibitive to a MMF being a competitive product.

Question 15: A conversion of MMF's to special purpose banks is not supported. Many investors in MMF's prefer it as an alternative to banking products. Furthermore, it is the typical banking approach that has placed MMF's under pressure, whereas if the pure concept of MMF's as a pure money market was maintained, it would not have been as problematic.

Question 16: See question 12 above and "High Level Comment".

Question 17: The preposition is not agreed. Additional/specific requirements of pricing and reporting of prices would be required.

Question 18: Comment to this question is contained within comments to the other questions.

Question 19: The main problem with marking to market in South Africa is that many money market instruments do not have a daily market price. Large issues of instruments that are fully taken up by one MMF; the issuer does not maintain a daily price and only revisits the issue on date of maturity

Question 20: It is suggested that amortized cost accounting may be appropriate for instruments not priced in the market daily. There should certainly be rules within which amortized cost accounting is applied. The practical implications would relate to the difficulties around managing a portfolio where

a part of instruments are valued mark to market and another by amortized cost accounting. General restrictions on a fund's WAM or WAL should always be a mechanism to manage liquidity of a fund.

Daily to weekly monitoring is applied in South Africa, depending on frequency of trades.

The set of conditions applicable in South Africa is attached as 'Annexure A', which has been effective in managing MMF's thus far.

Question 21: A minimum level of assets with 7 day liquidity is certainly a possibility. However, this should form part of the total assets of the portfolio representing the investments of investors and not an additional requirement. It should also be part of the calculated maximum WAM/WAL. No asset should be dated longer than 12 months but should be capable of being negotiated and transferred in the money market. The spread of assets between different issuers should remain an important aspect of managing concentration risk.

Question 22: Due to the nature of intermediaries, it is often difficult to know the investor that would make the redemption requests. Furthermore, MMF's have a very large client base and it is impractical to expect the required knowledge of redemption patterns or possibilities.

Redemptions from large institutions can be managed through contracted periods for pre-warning of large redemptions. However, such a redemption cannot be made absolutely subject or pre-warning.

It is suggested that CIS's be encouraged to differentiate between portfolios that market mainly to large investors as separate to those marketed mainly to retail investors, so as to protect retail investors from the effects of large redemptions.

Thus, the fund manager can be required to know those large corporates that invest with them and to have specific arrangements in place – however, this is not practical for retail investors.

Question 23: Full redemption restrictions are not appropriate or suitable for MMF investors. The reality is that a liquidity fee will not be effective due to its relative small size versus the redemptions. The imposition of a liquidity fee under circumstances of illiquidity would certainly create a further run on the fund, exacerbating matters. The concept of a liquidity fee stands in opposition to the nature of a MMF and the reasons why they are invested in.

However, there remains the possibility that contractual arrangements can be made with some individual large corporates who are prepared to be subjected to such liquidity "penalties".

Question 24: Minimum balance requirements are being utilised in South Africa to a large extent, mainly to differentiate the MMF as an investment from deposit investments and to avoid the negative effect on costs over small investments. Thus, it could also be utilised from the perspective of managing liquidity (as one of the possible tools). It is not a concern to fund managers if small investments are transferred as they are not profitable. The only option would be to transfer the funds to banking products or other income type CIS funds.

Question 25: It could be effective to use a bid price for on-going redemptions exceeding a certain amount or portfolio portion, especially when applied together with the ring-fencing approach. Each large redemption or portion can be ring-fenced for a bid for the particular redemption.

Question 26: Redemptions in kind could always be a final solution as an offering to investors, but only once all other possible solutions have been depleted. Some portfolio securities cannot easily be divided and some securities are not transferable. Accordingly, this can only be a solution subject to the agreement of the investor.

Question 27: Gates could be applied but merely to move the portfolio from day to day illiquidity to next day's liquidity.

Question 28: It is agreed that the suggestion that the establishment of a private liquidity facility faces challenges that make the option unworkable as described. However, there may be workable variations thereof, such as a central liquidity fund receiving a very small portion of monthly total assets under management, acting as a form of an industry backstop fund.

Question 29: It is agreed that reliance on credit ratings as the main reference for investment quality of instruments should be removed. However, rating of a MMF itself should be permitted. This is a matter of permitting a low risk MMF to market itself competitively.

Question 30: Following on the comment to question 29, money market funds should be encouraged to obtain a high CRA rating. This would allow investors to differentiate their needs according to very low risk MMF's with slightly less returns and higher risk MMF's with slightly better returns. It is important however to disclose to investors what a particular rating implies, e.g. "an AA rating implies a X% possibility of the portfolio not being able to meet Y% of its obligations within Z period".

Disclosures around the application and meaning of CRA ratings are paramount.

Question 31: This question has been addressed in the High Level Comment at the beginning hereof.

Question 32: A global solution and global playing fields would always be preferable. However, it would be unrealistic to disregard the limitations and different policy approaches on various jurisdictions.