IOSCO consultation report on Money Market Funds. July 2012.

The IOSCO Technical Committee has published a consultation paper in which an analysis of the potential risks Money Market Fund (hereinafter MMFs) can entail for systemic stability and proposes different policy choices against such risks. The MMFs' objective is to preserve the capital (value of the investment) and provide daily liquidity to investors investing in a diversified portfolio of high-quality, short term fixed-rate instruments; this definition seeks to be broad enough to include products that could be marketed under different names.
The characteristic risk of MMFs is that, in the event that a perception exists that the fund may suffer a loss, investors may have an incentive to request a refund before the rest of the participants (susceptibility to runs). Several characteristics of MMFs contribute to this run risk, for example the fact that they have a constant net asset value and are simultaneously subject to credit, interest rate and liquidity risk.

MMFs can, indeed, have a net asset value (NAV) which is constant (CNAV) or variable (VNAV). The constant refund value exists in the U.S.A., some EU countries, Japan, China and Canada, and makes MMFs similar to bank deposits; sometimes CNAV funds offer liquidity in T, i.e., on the same day on which refund is sought, while IIC investors generally must wait for T +1 to get the money from the settlement of a refund. In the event of massive refund requests, in the CNAVs, the losses are concentrated in the shares / shareholders which remain in the MMF, which exacerbates the tendency to be the first to request a refund. The CNAV uses the amortised cost method to value all its assets, while VNAV funds can use this method to assess some of their assets, which may in practice cause the net asset value of these funds to fluctuate very little. This paper discusses, within their legislative options, the following regarding the CNAV / VNAV contrast:

The establishment of a compulsory variable net asset value would entail prohibiting valuing assets with the amortised cost method.

The compulsory conversion to variable net asset value would reduce the expectations of the investors that MMFs are insensitive to losses and therefore the potential risk of a stampede when a fund does not meet said expectations. It is argued in favour of this option that the incentive to seek refund when the assets are valued at market prices (marked-to-market) is reduced because the advantage of moving first disappears as the refund value now reflects the losses, thus reducing the transfer of losses to investors who remain in the background.

However, there is evidence that both types of MMFs, those with constant and variable net asset value, behave similarly; there is also an incentive to seek refund in the VNAV funds due to the fact that the limited liquidity of their investments can reward the early investors in applying for refund. Additionally, elimination of funds with constant net asset value (CNAV) and could be detrimental to the short-term credit market (for example, commercial role and local authority funding in the short term where MMFs are dominant). In the USA, there may be a transfer of funds to less-regulated or unregulated vehicles. Moreover, the transition to VNAV involves other challenges: for example, in the U.S.A., cash managers sometimes have restrictions on investing in funds with varying net asset value (VNAV).

Other structural alternatives that would maintain a constant NAV are the following:

1) Buffers of the NAV alone or combined with other measures (for example, restriction on refund). The MMF can create a capital reserve by retaining a portion of its income as protection against potential losses, so that it would absorb any losses of the portfolio assets of the MMF, and would prevent deviations from occurring in the fixed asset value. The advantage of this option is that since the resources exist to cover a certain quantity of losses, application for mass refunds by investors is discouraged. The disadvantage is that its accounting, tax, and its operational regulation may encounter obstacles or problems: an important consideration is the time necessary to establish the reserve and it if it considered too long, it will not be operational at the beginning and, if too short, it may cause malfunctions; the size is also a critical issue and, finally, this option may give rise to some transfer of current participants' profits to future participants who profited from the reserve.

The establishment of this reserve can be through the issuance of a fixed percentage of subordinate shares to absorb the first losses and, in return, receiving a capital fee; this issuance could be signed by the sponsors. At regular intervals, if the subordinate shares fall below a certain level, the MMF must replenish the minimum capital by issuing new shares and, if they exceed that level, the excess capital may be reimbursed. This model of subordinate share issuance encourages prudent risk management and they would be placed by investors seeking high returns in exchange for high risks. On the other hand, it may be difficult to place this kind of share and at the same time, the mechanism must be difficult to implement with low interest rates if they have to meet the capital fee payments. The reserve may also be made up of three other alternatives: 1) retaining a portion of the income generated by the assets it invests in the MMFs to create a reserve to absorb future internal losses, 2) requiring that participants subscribe for some number of capital shares (equity capital) as a condition of constant net asset value (CNAV), and 3) require the sponsor to provide capital to MMFs that would be reserved to deal with possible future losses.

2) Private insurance contract. The insurance contract acts as a liquidity screen against the risks of massive requests for refund. The sponsors would stand on the front line to hold the first tier of loss to a limit, and private insurers would be assigned the next tier of loss against each individual participant. A final protection from the government in the event of extraordinary or catastrophic losses might also be possible potential claims arising from them. While it seems a good theoretical possibility, in practice it is unlikely that private insurers would like to cover such risks, and even that this possibility is feasible. A practical issue that now arises is how to price the risk they would assume; there are also other complex challenges in the design and implementation similar to those of the liquidity facility.

3) Conversion into Special Purpose Banks. The MMFs would be reorganised as banks subject to banking supervision and regulation due to their functional similarities. The equalisation would require capitalisation and the fulfilment of other requirements, which would reduce capacity in the short-term credit market. It would also be necessary to consider possible interactions between these new banks and the existing banking system, so that investors do not lose financing opportunities.

4) Establishment of a two-tier system. The two-tier system has, in turn, two options: a) Allow both MMFs with constant net asset values (CNAV) and variable net asset values (VNAV). Investments of the MMF (CNAV) will be subject to higher demands, and these funds will participate in an insurance scheme that allows investors to enjoy greater protection, while the VNAV funds have greater flexibility in their investments and normally offer higher yields in exchange for less protection, but they would not be required to access external sources of liquidity or insurance, and b) Allow MMFs with fixed refund values, but reserving the fixed redemption value MMFs, or institutional or non-institutional investors. This option aims to protect the possibility of contagion to non-institutional investors if institutional investors seek refunds en masse but, in practice, in some markets there are no non-institutional investors and, if there are any, they are indistinguishable from the use of omnibus accounts for investment in MMFs.

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