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**C/O BANK FOR INTERNATIONAL
SETTLEMENTS CH-4002, BASEL,
SWITZERLAND**

fsb@bis.org

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AFG's feedback to the FSB's background note on "Shadow Banking: Scoping the Issues"

The Association Française de la Gestion financière (AFG)¹ welcomes the opportunity offered by the FSB's open debates around shadow banking to express the French asset management's opinion on the topic. It is all the more important as French Variable NAVs MMFs represent about a third of the European market.

Our answer will focus on European and more specifically French MMFs.

¹ The Association Française de la Gestion financière (AFG)¹ represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

1. MMFs are fully lit regulated investment products which are not part of any “Shadow banking”. They are key to the proper financing of the economy

Money market funds have been continuously and for several years already under the close scrutiny of regulators and central banks (in France since 1986 and now in Europe). Their assets under management, portfolio composition, investor disclosures or their use as an investment for banks (Basel III) or corporate treasuries (IAS 7) are screened by regulators.

It would therefore completely inexact to state that this activity would be operated “in the shadow” of any regulation. On the contrary, they are in full light.

Also, these investment products are already very regulated in Europe. Any additional regulatory measure would have an impact difficult to foresee for these products which are useful for their clients and absolutely key to the proper financing of the economy, including banks and smooth functioning of the money market. However, it is difficult to imagine that an additional regulation may have any additional material effectiveness towards the stated goal of reducing the systemic risk, but on the contrary it could have dramatic consequences on the market players.

About two thirds of European money market funds are operated through a structure having a variable NAV and in France we only have funds with variable NAVs. From a tax standpoint, the French investor’s tax regime gives no incentive to invest into one or the other types (VNAV or CNAV) of accounting for the NAV of a fund.

We do not think that money market funds pose a systemic risk. Taking specially into account the market and regulatory environment in France, we find no grip to validate a “shadow banking” hypothesis.

2. Money market funds are not similar to banks

2. 1. The transformation risk is very limited and tightly monitored

The European regulation imposes new strict standards on funds that use the label “money market funds”. In addition to being regulated by the steady and strict rules of the UCITS Directive (rules on funds, their management companies and depositary in particular), starting with 1st of July 2011, new stringent rules are set on the portfolio composition of European MMFs so to ensure that the potential of transformation in the fund is limited. For instance:

- each and every instrument maturity is limited to 397 days for short term MMFs, 2 years with a yearly reset for MMFs;
- WAL (weighted average life) is limited to 120 days for short term MMFs and 12 months for MMFs
- WAM (weighted average maturity) is limited to 60 days for short term MMFs and 6 months for MMFs

This reinforced set of rules combines into a very robust regulatory environment that materially makes insignificant the already limited possibilities offered for current MMFs² to transform short term financing to long term uses.

MMFs offer transparency on the risk levels into the fund and they cannot be categorised as “opaque products”.

Money market funds put together investors on one side and short term financing needs on the other, but they do not create credit risk.

2.2. No implicit or explicit guarantee is promised to investors

French MMFs operate through a variable NAV, as any other asset management product. Investors are informed that they have bought to a product whose value depends on the market price of the instruments composing the portfolio. Thus, their value may decrease, as it happened in the recent past. In this case, the redemption proceeds correspond to the fund's NAV (the decreased value), without having to maintain the NAV to a certain level (no legal nor implicit obligation to intervene).

the French type of MMFs do not contain in their name any term that would imply the obligation to maintain the NAV to a certain level. Funds prospectuses clearly indicate that the fund does not benefit from any guarantee on the NAV level. There is no underestimation of the cost of its risks and therefore there is no funding advantage relative to banks. It happened in the past that a handful of sponsors intervene to maintain the NAV on some of their funds, but it should be clearly stated that it was done on a voluntary basis and was linked nor to a legal obligation nor to a potential less precise information that would have been given to investors. Indeed, there are cases when the value of VNAV French MMFs decreased without entailing any “run”.

There is therefore no mechanism in the way they operate that mechanically would imply the need to have recourse to a liquidity facility, and no incentive to front runners to sell in order to get out of a fund first, as the value is adapted on an ongoing basis.

In our market it is clearly admitted that MMFs are *managed* products and they are not perceived by investors as a deposit-like instruments. They are not concerned in any way by a potential “banking arbitrage” risk.

A daily redemption vehicle protects all investors equally if it reflects current value. The valuation principles are an issue in a volatile environment and in the case of high redemptions. The more the fund is marked to market (versus linearization or model), the less the difficulties. In our market, due to the Marked to Market valuation of the portfolios (with an exception on the 90 day instruments), liquidity and credit risks are transparent.

² The French regulator (AMF) had already imposed in France a classification on MMFs. So-called « enhanced MMFs » have never been MMFs, they were belonging to the « balanced » or the « bonds » classifications.. In France it's the Regulator (AMF) that makes an official definition and classification.

Our investors' base is principally made of corporate investors and institutional investors. The contagion risk to the banking system as an investment is limited (less than 1% of investors are banks).

We would finally like to stress that global monitoring is essential in a globalised market. If we perfectly agree that a harmonised regulation is a desirable feature, it is however essential that local market true particularities be taken into account to avoid unintended effects. There is no one-size-fits-all yet into MMFs environment across borders (market, regulation, investors habits and investors regulation, etc) and before setting new global regulation, an in-depth study may prove useful so that “the wrong medicine is not given to a healthy patient”.

It is very logical and desirable that regulators make sure that the upgraded regulation of banks does not lead to a development of a “shadow banking” system. Having seen their assets decrease since the crisis, MMFs surely cannot be suspected of benefiting from the updated banking regulatory standards. Variable NAV MMFs are in full light and far from being in any “shadow”. Being not similar to banks, they are submitted to a strong and recently strengthened regulatory and supervisory system.

If you need any further information, please don't hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr) or myself at +33.1.44.94.94.14 (p.bollon@afg.asso.fr).

Sincerely Yours,

(signed)

Pierre Bollon