Box 2:

FINANCIAL STABILITY RISKS OF MMFS IN EUROPE

According to the ESRB's Occasional Paper on Money Market Funds in Europe and Financial Stability, there are four main risks underlying MMFs and their activities:

A. MATURITY TRANSFORMATION

Money Market Funds in Europe may hold risky assets on their balance sheets that have a maturity date of one year or longer. However, the same funds also issue shares to investors that, in addition to being perceived as "safe," must be redeemable on demand. Under certain conditions, such a maturity mismatch may lead to the inability of the MMF to absorb losses in the event of a sudden investor withdrawal of funds. In the absence of an official liquidity backstop and a "bank-like" set of prudential regulation, MMFs are considered to be at risk of runs.

B. DEPOSIT-LIKE FEATURES

MMFs are "deposit-like" though they are not supported by any form of official guarantee as is the case for bank deposits. The perception that MMF shares are relatively "risk-free", combined with the widespread presence of CNAV funds, may result in the perception by investors that investing in an MMF provides a similar level of security as a bank deposit, but with a higher yield. However, there are clearly risks involved in MMF investment.

C. CASH-LIKE TREATMENT

Given that MMFs are also used as cash management tools, they may be perceived as cash-equivalent. Under International Accounting Standard (IAS) rules[16], "…cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash and that are subject to an insignificant risk of changes in value."

D. INVESTORS AND RUN RISK

The failure of Reserve Primary illustrated the effects that a sudden investor run can have on an MMF as a result of redemption pressures. At least in the U.S. case, redemptions come primarily from institutional investors[17] which tend to be more risk averse than private investors. Additionally, institutional investors may possess greater resources for - and have access to - better MMF monitoring facilities which can lead them to redeem shares pre-emptively in comparison to private investors according to the "first-mover" advantage.

16 This corresponds to IAS rule 7.7 regarding cash and cash equivalents. Note that the IASB is considering eliminating the concept of cash equivalents which may help to mitigate some of the risks associated with MMFs.

17 Please see the Financial Stability Oversight Council's (FSOC) 2011 Annual Report.