MONEY MARKET FUNDS ("MMFS")

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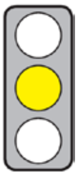
Centrum für Europäische Politik

KEY ISSUES

Objective of the Regulation: The Commision wants to increase the stability of money market funds ("MMF").

Affected parties: Money market funds, investors, companies, insurance companies, banks and regulatory authorities.



Pro: The rules on investment policy, maturity and liquidity increase investor confidence.

Contra: (1) Cash buffers for CNAV-MMFs are not suitable for striking the right balance between investor confidence and financial market stability. The only alternative is a general ban on CNAV-MMFs.

(2) Banning MMFs from soliciting external credit ratings from rating agencies obstructs the efficient allocation of capital.

CONTENT

Title

Proposal COM(2013) 615 of 4 September 2013 for a **Regulation** of the European Parliament and of the Council on **Money Market Funds**

Brief Summary

► **Background**

– Money Market Funds (MMFs) are highly liquid investment funds which invest their investors' capital in short-term financial instruments. In the EU they are operated
  - as UCITS investment funds (collective investment undertakings, "UCITS" Directive 2009/65/EC, see cep**PolicyBrief**) or
  - as alternative investment funds ("AIF" Directive 2011/61/EU, see cep**PolicyBrief**).

– Investors have a contractual right to exchange their shares in money market funds for cash at any time. Sudden, hasty cash withdrawals ("runs") can force money market funds to sell assets prematurely. This can give rise to losses. (P. 3)

– In Europe, money market funds hold approx. 38% of the banking sector's short-term debt and approx. 22% of the short-term debt issued by governments and non-banking corporates. According to the Commission, money market funds are therefore systemically relevant. (P. 2)

– The Commission classifies money market funds as "shadow banks" (P. 2 et seq., see cep**PolicyBrief**)

► **Scope and Objective**

– The Regulation applies to all UCITS and AIFs which invest in assets with a maturity of up to two years and aim to provide returns in line with money market rates or to preserve the value of the investment (Art. 1 (1), sub-para. 1). Funds offering to outperform the money market rate by a "slight" margin are "not automatically" excluded from the scope of the Regulation (Recital 15).

– The Regulation distinguishes between
  - "standard MMFs", which invest in assets with a maturity not exceeding two years and
  - "short-term MMFs", which invest in assets with a maturity not exceeding one year.

  CNAV funds ("Constant Net Asset Value") are a special form of short-term MMF.

– The Regulation introduces uniform EU rules for money market funds. The Member States are not permitted to add any additional requirements (full harmonisation) (Art. 1 (2)).

► **Authorisation**

– All UCITS and AIFs which fall under the Regulation must be authorised as MMFs. This authorisation applies EU-wide (EU Passport). (Art. 3 (1))

– Only funds which are authorised as "MMFs" may refer to themselves as such (Art. 5 (1), sub-paragraph 1).

► **Rules on the investment policy of MMFs**
Permitted investments

– An MMF can only invest in:
  - money market instruments, i.e. short-term trade receivables traded on the money market, which (Art. 8 (1) (a) in conjunction with Art. 9 (1) (b) and (c) and Art. 16)
    - have a residual maturity of 397 days or less and
    - originate from an issuer which has been awarded the highest or second highest rating by the MMF's internal rating system,
  - deposits with credit institutions which are repayable on demand or may be withdrawn at any time (Art. 8 (1) (b) in conjunction with Art. 11),

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- financial derivatives (Art. 8 (1) (c) in conjunction with Art. 12)
- reverse repurchase agreements – where an MMF lends money against securities and the counterparty undertakes to repurchase the securities at a specified price – provided they do not accept securitisations as security (Art. 8 (1) (d) in conjunction with Art. 13), and
- securitisations underlying corporate debt of high credit quality and liquidity (Art. 9 (1) (d) in conjunction with Art. 10 (1)).

– Standard MMFs are also allowed to invest in money market instruments, with a maximum residual maturity of 2 years, provided the yield is regularly adjusted in line with money market conditions at least every 397 days (Art. 9 (2)).

Provisions on diversification of investments

– MMFs can only invest up to a maximum of 10% of their assets in securitisations (Art. 14 (2)).
– They can only invest their assets in certain investment categories up to a fixed maximum percentage (Art. 14 (1) to (5) and Art. 22 (2) and 3).
– The following percentages apply to the individual investment categories (Art. 14 (1)-(5) and Art. 22 (2) and (3)):

Permitted exposure to the same counterparty:	Short-term MMFs	Standard MMFs
• Money market instruments	5 %	10 %
• Deposits	5 %	
• Financial derivatives	5 %	
Permitted total amount of money market instruments, deposits and financial derivatives with the same counterparty	10 %	15 %
Permitted exposure to the same counterparty from reverse repurchase agreements	20%	

– The national regulatory authority can allow an MMF to invest 100% of its assets in money market instruments which are issued or guaranteed by governments or EU bodies (Art. 14 (6)).

Rules on maturity and liquidity of investments

– MMFs must invest their funds in such a way that they are able to comply with redemption requests from investors at any time. In order to guarantee this, the Regulation introduces upper limits on maturity and lower limits on liquidity of investments (Art. 21 and Art. 22).
– The Regulation provides for the following limits (Art. 21 and Art. 22):

	Short-term MMFs	Standard MMFs
Weighted average maturity of assets	maximum 60 days	maximum 6 months
Weighted average life of assets	maximum 120 days	maximum 12 months
Proportion of daily maturing assets	at least 10%	
Proportion of weekly maturing assets	at least 20 %	

► **Valuation rules for the investments**

– MMFs must value their assets at least on a daily basis and - where possible - using the mark-to-market method. Where the latter is not possible, they must use their own valuation models (Art. 26 (4))
– MMFs must calculate the net asset value per unit - i.e. the price at which the shares are issued or redeemed - at least once a day (Art. 27 (3) and Art. 28 (1).

► **Specific requirements for short-term MMFs with constant net asset value ("CNAV")**

– "CNAV MMFs" (Constant Net Asset Value) are short-term MMFs with a constant net asset value. Investors can exchange their investments at any time (at least) at the original unit value. (Art. 29 (1))
– CNAV MMFs must be explicitly issued as such (Art. 29 (1).
– CNAV MMFs must hold a cash buffer at all times, in a separate reserve account, amounting to at least 3% of the assets. (Art. 29 (2) (a) in conjunction with Art. 30 (1) and (4)
– If the cash buffer falls below 3 %, the CNAV MMF must either replenish it itself or obtain external support such as by way of the sponsor bank (Art. 33 (1) in conjunction with Art. 35 (3).
The sponsor bank is the bank which sets up the money market fund.
– Where the cash buffer remains below 2.9% for a prolonged period, the CNAV MMF must value its assets using mark-to-market and notify the investors of this (Art. 33 (2)).
– CNAV MMFs must set up the full buffer within three years from the date of entry into force of the Regulation. Transitional rules apply. (Art. 43 (3))

► **Transparency**

– MMFs must inform their investors and potential investors (Art. 37)
- whether they are a short-term MMF with a constant ("CNAV") or variable asset value or a standard MMF,
- whether the risk of loss of the principal will be borne by the investors,
- which methods will be used to calculate the net asset value (Art. 37 (4)).

– MMFs are not permitted to solicit or finance a credit rating agency for rating the MMF (Art. 23).

Main Changes to the Status Quo

- Until now, money market funds were only subject to the EU rules on UCITS (Directive 2009/65/EC, see cep**PolicyBrief**) and AIFs (Directive 2011/61/EU, see cep**PolicyBrief**). In future the Regulation will apply.
- Until now, the Member States decided whether to apply the non-binding guidelines of the European Securities and Markets Authority (ESMA) [Ref. CESR/10-049] to money market funds. In future, all money market funds will be subject to the Regulation which largely corresponds to the provisions of the guidelines.

Statement on Subsidiarity by the Commission

According to the Commission, the cross-border interconnection of money market funds and their systematic impact on financial stability requires coordinated EU action.

Policy Context

In 2010, as a reaction to the liquidity problems of money market funds during the financial crisis, the Committee of European Securities Regulators (CESR) (formerly ESMA) published guidelines for money market funds. In 2012, the International Organisation of Securities Commissions (IOSCO) recommended measures to reduce the susceptibility of money market funds to investor runs. At about the same time, the European Systemic Risk Board (ESRB) published recommendations on the regulation of money market funds ESRB/2012/1]. Also in 2012, the European Parliament, in a Resolution, called on the Commission to submit statutory rules for money market funds.

Legislative Procedure

4 September 2013	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Internal Market
Leading Committee of the EP:	Economic and Monetary Affairs, Rapporteur: Neena Gill (S&D, UK)
Leading Federal Ministry:	Federal Ministry of Finance
Leading Committee of the BT:	Finance
Decision-making mode in the Council:	Qualified majority (Adoption by a majority of the Member States and with 260 of 352 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (Ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Money market funds (MMFs) fulfil important economic functions. Firstly, they intercede between supply and demand in relation to short-term cash. Secondly, - compared to conventional banks - they allow companies and private individuals a greater diversification of risk in relation to short-term investments. Thirdly, MMFs are important financiers: They invest their investors' money in short-term corporate and government debt. Above all, they are an important source of finance for banks.

Against this backdrop, **the** proposed **rules on investment policy for MMFs** are appropriate. The upper limit of 10% for securitisations and the mandatory diversification of investments - by issuer in the case of money market instruments, deposits and financial derivatives - **strengthen investor confidence in MMFs and reduce the impact of a failure of the MMF's counterparties. The rules on maturity and liquidity help to ensure that the cash is available to investors at short notice.**

These rules cannot, however, prevent CNAV MMFs in particular from presenting a significant risk to the stability of the financial market. The reason for this is the promise made to investors by CNAVs that they can redeem shares at any time at the promised redemption value. If, due to pressurised market conditions, investors doubt whether the CNAV MMF can keep this promise, they will be motivated to exchange their units, if possible, before other investors ("first mover advantage").

This sort of sudden, self-perpetuating withdrawal of funds ("run") forces CNAV MMF to convert its investments into cash as quickly as possible. This risks giving rise to two effects which reinforce each other: Firstly, the associated withdrawal of CNAV deposits from banks causes them to have liquidity bottle-necks resulting in the additional withdrawal of conventional bank deposits by other customers. This can represent a threat to a bank's existence. Secondly, in the event of an investor run, CNAV MMFs also have to sell their money market instruments rapidly and in large volumes. This causes the price of these instruments to fall, in turn, prompting investors in other CNAV MMFs to exchange their shares which can result in a further investor run. In addition, such runs can jeopardise sponsor banks if the latter consider themselves bound to make up for losses in the money market fund in order to protect their reputation.

The problem of "first mover advantage" is inextricably linked to the CNAV MMF business model because every investor who keeps his money in funds, must be able to assume that, in a pressurised market situation, the fund has to finance the redemption of shares at the original (higher) value at the cost of the remaining shares. A cash buffer for CNAV MMFs may reduce this stimulus but it causes insoluble problems. On the one hand, the buffer must be large enough so that a majority of the investors, even in a pressurised market situation, refrain from withdrawing cash. On the other hand, due to the cost involved, a permanently large buffer will jeopardise the CNAV business model and can only be realised with the support of the sponsor bank. This, however, puts the stability of the sponsor bank at risk or will be detrimental to the credibility of the buffer. It is therefore necessary - as distinct from the Commission's proposal - to have a variable buffer which reflects the latest situation on the market. Such a buffer is highly procyclical however. **Cash buffers for CNAV-MMFs are therefore unsuitable for striking the right balance between investor confidence and financial market stability.**

The alternatives to a buffer, currently under discussion - **mandatory conversion of flagging CNAV MMFs into MMFs with variable redemption value and liquidity management measures,** such as discounts on the redemption value - **do not provide a solution to pressurised market situations**. They do not take the "first mover advantage" away from investors in CNAV funds **because the investors will anticipate their use.** Thus, the "run" will not be prevented but will actually take place sooner.

The only alternative to the buffer is therefore a general ban on CNAV MMFs and the mandatory conversion of existing CNAV MMFs into short-term MMF funds with variable redemption value.

Banning MMFs from soliciting external credit ratings from rating agencies obstructs the efficient allocation of capital and distorts competition. Ratings agencies can evaluate risks better than most investors. In addition, many companies that have large cash holdings for reasons of internal risk management, will not invest in MMFs without a rating. They could, as a result, be pressured into making a conventional bank deposit. The concentration of liquid funds belonging to companies in their "house" banks may in turn intensify the "too big to fail" problem of large banks.

Legal Assessment

Legislative Competency

The Regulation is correctly based on the internal market competence (Art. 114 TFEU) as diverging national rules could obstruct cross-border investment in MMFs.

Subsidiarity

Unproblematic.

Proportionality with Respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

The duty for CNAV funds to set up a buffer of 3% represents a restriction of the freedom to conduct a business (Art. 16 EU Charter of Fundamental Rights). Although a buffer may in itself reduce the "first mover advantage" for investors, a buffer of 3% is only suitable for this if the level is sufficient to reduce the "first mover advantage", and only necessary where a lower level would not be sufficient. It is not possible to determine objectively that neither of these statements applies in the case a 3% buffer. The legislator therefore has a corresponding scope for discretion so that the proposed provision does not constitute a breach of fundamental rights. This does not, however, change the economic concerns about the effectiveness of the rigid buffer.

Impact on German Law

The Capital Investment Code (KAGB) must be amended despite the direct effect of the Regulation. In particular, CNAV funds will, in future, be eligible for authorisation.

Conclusion

The rules on investment policy for MMFs increase investor confidence in MMFs and reduce the impact of a failure of the MMF's counterparties. The rules on maturity and liquidity help to ensure that the cash is available to investors at short notice. Cash buffers for CNAV MMFs are not suitable for striking the right balance between investor confidence and financial market stability. Mandatory conversion of flagging CNAV MMFs into MMFs with variable redemption value and liquidity management measures will not provide a solution to pressurised market situations because investors will anticipate their use. The only alternative to the buffer is therefore a general ban on CNAV-MMFs. Banning MMFs from soliciting external credit ratings from rating agencies obstructs the efficient allocation of capital.

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