European Union: agreement on money market funds regulation

On 14 November 2016, the European Council, the Commission and the Parliament reached a provisional agreement on a draft regulation on money market funds (MMFs).With assets under management of around EUR 1 trillion, MMFs are mainly used to invest excess cash for short periods of time. They constitute an important instrument for investors as they offer the possibility to diversify their excess cash holdings, while maintaining a high level of liquidity.However, as the 2008 financial crisis demonstrated, MMFs are vulnerable to shocks and may even amplify risks throughout the financial system. In fact, investors generally tend to redeem investments as soon as they perceive a risk, which can force funds to sell assets rapidly in order to meet redemption requests. This can cause an investor run and, by way of consequence, liquidity difficulties for an MMF, potentially producing further negative effects on other parts of the financial system.In 2010, the CESR, which has since been replaced by the European Securities and Markets Authority (ESMA), published guidelines on a common definition of European MMFs, aimed at improving investor protection in this area. However, not all EU countries applied these guidelines.Since they have features that are similar to bank deposits with easy access to liquidity and relative stability in value, MMFs have been at the centre of international debate on shadow banking. In particular, recent work by the Financial Stability Board (FSB) and the Board of the International Organisation of Securities Commissions (IOSCO) has highlighted the systemic importance of MMFs activities, as well as the need for further regulation in this area.Based on a 2013 proposal by the European Commission, the present draft regulation lays down a uniform set of rules for MMFs covering authorization, eligible investments, portfolio composition, internal credit quality assessment, valuation rules, transparency and reporting, as well as liquidity risk management.It has the objective of harmonising the EU legal framework for MMFs to safeguard the integrity of the internal market and to make them more shock-resistant. Thus it sets out to maintain the essential role that MMFs play in the financing of the real economy.

Types of MMFs

The draft regulation distinguishes between three types of MMFs: (a) those that offer a variable net asset value (VNAV) that mainly depends on market fluctuations; (b) those that offer a constant net asset value (CNAV) and aim to offer share purchases and redemptions for a fixed price; and (c) those that represent a compromise between constant and variable net asset value funds (LVNAV)[1]. In addition, the draft regulation distinguishes between short-term and long-term MMFs.

Authorisation requirements

UCITS MMFs need to be authorised under both regimes, that is, the UCITS Directive 2009/65/EC and the MMF regulation. AIF MMFs are subject to the authorisation in accordance with the MMF regulation provided that the AIFM has been authorised to manage MMFs.

Portfolio composition

Eligible assets include money market instruments, bank deposits with less than 12 months’ maturity, financial derivative instruments for hedging of interest rate or exchange rate risks, repurchase and reverse repurchase agreements, units or shares of other MMFs. An MMF will not be allowed to short sell money market instruments, securitisations, asset-backed commercial papers (ABCPs) and units or shares of other MMFs; take any direct/indirect exposure to equities or commodities, enter into securities lending or borrowing agreements, and borrow and lend cash.

Diversification and concentration rules

In general, an MMF will be permitted to invest up to 5% of its assets in money market instruments, securitisations and ABCPs issued by the same issuer. Moreover, it may invest no more than 10% of its assets in deposits with the same bank. In addition, the aggregate exposure to securitisations and ABCPs is limited to 15% of the assets of an MMF. Other than further diversification rules, including those related to investments in other MMFs, the draft regulation contains a concentration rule, according to which an MMF may not hold more than 10% of the money market instruments, securitisations and ABCPs issued by a single body.

Internal credit quality assessment

The manager of an MMF will be required to implement a prudent and well-documented internal credit quality assessment procedure to evaluate the credit quality of the money market instruments, securitisations and ABCPs in which the MMF will invest. The assessment methodologies will be subject to annual review and validation based on back-testing.

Portfolio valuation rules

The assets of an MMF must be valued on a daily basis using mark-to-market whenever possible. If the market data is not of sufficient quality, a mark-to-model valuation method may be used. In addition, CNAV MMFs may be valued using the amortised cost method.

Transparency and Reporting

To their investors, MMFs shall report on a weekly basis a range of information, including the maturity breakdown of the portfolio, the credit profile of the MMF, the total value of assets and the net yield of the MMF. To the competent authority, the manager will be required to report information on a quarterly basis, including information on portfolio composition and valuation; results of stress tests, portfolio indicators including, yield and liquidity, risk management measures and investor information.

Liquidity risk management

The manager should put in place a due diligence on investors with a view to anticipating the effect of concurrent redemptions, taking into account the type of investor, their shareholding and the evolution of inflows and outflows.What is more, the manager will be required to put in place sound stress-testing processes related to events live changes in liquidity of portfolio assets, in credit risk of assets, in levels of redemptions, movements in interest and exchange rates and macro systemic economic shocks.It is noteworthy that an MMF may not receive any external support from a third party, including the sponsor of the MMF, in the form of cash injections, purchase of the assets of the MMF at an inflated price, purchase of units of the MMF, implicit or explicit guarantee.

Timeline

The MMF regulation is expected to enter into force in the second quarter of 2017. Existing MMFs will have 18 months after the entry into force to submit an application to their local authority for approval under the MMF regulation.

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[1] This newly proposed class allows an MMF to issue and redeem units at a constant net asset value as long as this is within 20bp of its actual NAV, based on the amortised cost accounting approach for assets maturing within 90 days.