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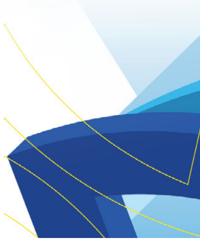

Capital Markets Union

A more ambitious reform of money market funds

May 2015

The Money Market Fund (MMF) Regulation is one of the post-crisis flagship reforms specifically requested by the G20, the FSB and IOSCO with the view to address the shortcomings associated with a product that demonstrated its susceptibility to runs during the 2008 financial crisis. The position recently adopted by the European Parliament constitutes an important step forward on the way to a reform but does not fully address the financial stability concerns associated with the Constant Net Asset Value (CNAV) funds' structure and may further create new types of risks. Only a reform which will require all MMF to, ultimately, float their NAV, similarly to any other investment fund, would limit the incentive for investors to run in times of stress (associated with the "first mover advantage") and put an end to the confusion between such funds and bank deposits. MMF represent an essential source of short-term funding for a wide range of European financial institutions, issuers and public bodies. Europe must demonstrate its ability to reach a satisfactory agreement that would respond to the financial stability concerns identified while preserving the key role played by MMFs in the short-term financing of the European economy. Europe's credibility is at stake.

Why is a reform needed?

In September 2013, the European Commission published a draft Regulation on Money Market Funds (MMFs) with the view to increase the robustness of this category of investment funds and make them more resilient to investor runs, thereby securing a product representing an essential source of short-term funding for a wide range of European financial institutions, issuers and public bodies.

This draft Regulation was also the European response to the recommendations expressed by the G20, the FSB and IOSCO which urged securities regulators worldwide to strengthen the regulatory framework applicable to money market funds in general and to Constant Net Asset Value (CNAV) MMFs specifically as these pose a threat to the financial system as evidenced by the demise of the Prime Reserve Fund in September 2008. Their valuation model (amortized cost accounting) and their use of the penny-rounding method convey a false impression of stability and unduly create the expectation that these funds are risk-free equivalents to bank deposits, making them subject to an increased run risk and a "first-mover advantage".

The draft Regulation proposed a comprehensive framework of rules applying to all types of money market funds whether they are CNAV or Variable Net Asset Value (VNAV) funds and irrespective of the European directive they fall under (UCITS or AIFM Directives). The proposed rules built upon the CESR[1] Guidelines that were published in May 2010 and which were the first European attempt to harmonize MMF regulation in the aftermath of the financial crisis as well as on the 2012 IOSCO policy recommendations.

The proposed regulation spanned across a broad array of topics ranging from eligible assets, diversification and liquidity ratios, transparency and reporting requirements, stress testing, know your customer policies, asset credit quality assessment etc. With regard to the treatment of CNAV MMFs specific risks, the Commission had proposed to require each of them to hold at all times a capital buffer amounting to 3% of its assets so as to mitigate the increased run risk these funds are exposed to.

1 Committee of European Securities Regulators (replaced by ESMA in 2011)

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The European institutions divided on the issue of the treatment of CNAV funds

On April 29th 2015, following several months of intense debates, the European Parliament endorsed the report prepared by its Committee on Economic and Monetary Affairs (ECON) and containing a set of amendments to the Commission's proposed Regulation on MMFs.

On the specific issue of the treatment of CNAV MMFs, the Parliament chose not to retain the capital buffer initially put forward by the Commission and instead preferred to circumscribe the use of the CNAV model either to funds that would be mainly invested in European public debt or to funds marketed to "retail investors" only, with retail investors defined in a strict sense (including charities, not for profit organisations, foundations, etc. but excluding individuals).

The Parliament also proposed the creation of a new type of hybrid funds, the so-called Low-Volatility Net Asset Value MMFs (LV NAV) which could still resort to the amortized cost valuation technique and display a stable NAV although under limited circumstances. Nevertheless, it is worth noting that the text foresees the extinction of such LV NAV MMFs five years after the entry into force of the Regulation, unless decided otherwise by the European Commission. In order to strengthen these three new products, the Parliament allows them to use liquidity management tools such as liquidity fees or redemption gates in case the level of the fund's liquid assets falls under predefined thresholds.

Besides, the text adopted by the Parliament also proposed to strengthen the stress testing requirements and the transparency rules for all types of MMFs. The Commission's initial suggestion for funds to put in place some liquidity buffers constituted of assets maturing within one or five days respectively was maintained although the version adopted by the Parliament suggests calibrating these buffers depending on the asset valuation method employed.

The need for a straightforward reform that addresses financial stability concerns while taking into account the specificities of the European money markets

The position adopted by the European Parliament shows the difficulty to bring a straightforward response to the systemic threat associated with CNAV MMFs. Although at the AMF, we see positively the fact that the debate is moving forward, we still consider that requiring CNAV funds to float their NAV ultimately – as any other investment product – is the only way to fully address the financial stability concern associated with the CNAV model and put an end to the confusion with bank deposits. All other options suggested so far do not address the concerns which were at the source of this regulation, i.e. (i) the financial stability risk posed by the first mover advantage embedded in the structure of CNAV funds and the incentive for investors to run out of the fund in times of market stress and (ii) do not clarify the hybrid nature of the product and maintain the confusion with bank deposits. Therefore, the options currently envisaged may only be considered as part of a transition phase. In this respect we support the Parliament's proposal of having a sunset clause for LV NAV MMFs and are in favor of extending it to both EU public debt funds and retail CNAV funds.

Besides, it should also be noted that the proposed solutions draw heavily on the American reform and do not sufficiently take into account the specificities of the European money markets. In our view, some options under consideration today may give rise to new types of risks; this is the case in particular for the proposed EU public debt funds which also raise a number of other issues such as how to define the credit quality criteria for the eligible public debt or how to avoid resorting to taxpayers money in case of problems.

Europe's credibility is at stake on this specific file considering that the need for a reform of the MMF sector from a financial stability standpoint was endorsed by the G20 at the Cannes Summit in 2011. In this respect, it should also be noted that the FSB is currently conducting a review with a view to assess the progress of the reforms undertaken on the money market funds sector. Against this background, it is of the utmost importance that Europe reaches an agreement on a satisfactory compromise that would address the financial stability concerns while preserving the key role played by MMFs in the short-term financing of the European economy.

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