

Money Market Funds

Measures to improve stability and liquidity

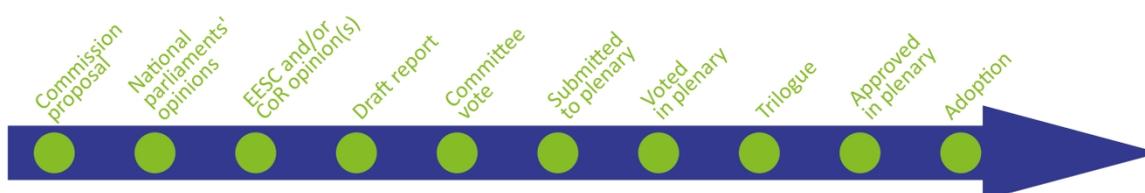
SUMMARY

Money Market Funds (MMFs) are a type of collective fund that invest in short-term debt and provide financing for financial institutions, corporations and governments. During the financial crisis their liquidity and stability were challenged, which prompted the Commission to propose a regulation on MMFs, in 2013. Its proposal aimed to improve their ability to weather stressed market conditions, mainly through establishing a capital buffer, introducing conditions on portfolio structure, addressing over-reliance on external credit rating agencies and improving their internal risk management, transparency and reporting.

The final text lays down rules and common standards to ensure that MMFs have a stable structure and improved liquidity, that they invest in diversified assets of a sufficiently high credit quality, and are able to deal with unexpected redemption requests. It was approved by the EP in April 2017 and by the Council in May.

Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds

<i>Committee responsible:</i>	Economic and Monetary Affairs (ECON)	COM(2013) 615 4.9.2013
<i>Rapporteur:</i>	Neena Gill (S&D, United Kingdom)	2013/0306(COD)
<i>Shadow rapporteurs:</i>	Brian Hayes (EPP, Ireland) Syed Kamall (ECR, United Kingdom) Petr Ježek (ALDE, Czech Republic) Fabio De Masi (GUE/NGL, Italy) Philippe Lamberts (Greens/EFA, Belgium)	Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly ‘co-decision’)
<i>Procedure completed</i>	Regulation (EU) 2017/1131 OJ L 169, 30.6.2017, pp 8-45	



Introduction

On 4 September 2013, the European Commission [proposed a regulation](#) aimed at enhancing the liquidity and stability of MMFs in Europe.

In order to be able to meet daily [redemptions](#) by their investors MMFs require a high degree of asset [liquidity](#). The Commission proposed setting minimum levels of daily and weekly liquid assets that MMFs are obliged to hold. This would be done by boosting the quality of the assets (i.e. refraining from illiquid investments) and by requiring funds' managers to conduct active monitoring of the redemption profile of its investors. In order to improve the stability of MMFs, the Commission proposes: (i) a mandatory capital buffer (reserves) sufficient to absorb the potential losses of MMFs that offer redemptions at a stable share price, and (ii) to clarify the rules concerning valuation of the assets in which an MMF invests, by limiting over-reliance (and mechanistic reliance) on ratings issued by external rating agencies. To achieve this, MMFs would have to set up an internal rating system based on a harmonised rating scale and an internal assessment procedure.

Existing situation

MMF market

EU-domiciled MMFs are based mostly in France, Ireland and Luxembourg,¹ which together represent more than 95% of the market.² There has been a steady decrease overall in the value of assets managed by MMFs since 2008, with a total fall of more than 30%. This has been primarily caused by a 48% (€448 billion) drop in the value of assets managed by the VNAVs. The value of assets under management in CNAV MMFs grew 7% (€29 billion) over the same period. Investors tend to prefer CNAV MMFs to VNAV MMFs mainly because of their stable net value, exemption from capital gains tax obligations and more rapid settlement. CNAV MMFs, which are the main subject of the regulatory proposals, hold around €540 billion (with a similar volume invested in VNAV MMFs).

Legal framework

The Commission estimates that around 80% of MMF assets and 60% of the funds (as entities) are covered by the rules of [Directive 2009/65/EC](#) on Undertakings for Collective Investment in Transferable Securities (UCITS). The remaining MMFs operate under the rules of [Directive 2011/61/EU](#), covering 'Alternative Investment Fund Managers' (AIFM).

The UCITS framework³ regulates the following areas: (i) key investor information (in the form of a standardised and harmonised disclosure document), (ii) rules for the conduct of UCITS management companies (aligning organisational requirements and rules of conduct for investment firms with the Markets in Financial Instruments Directive – [MIFID](#)) (iii), UCITS mergers and [master-feeder structures](#), and (iv) details of the notification procedure – used by a UCITS to gain access to the market in another Member State – together with common procedures for strengthening supervisory cooperation of Member States in their oversight of fund managers' cross-border activity.

The AIFM Directive provides a framework for monitoring risks posed by AIFMs, and lays out conditions under which they can operate across the internal market. Specifically, the rules concern: (i) the conditions and procedure for the determination and authorisation of AIFMs, notably the capital requirements; (ii) conditions concerning their operation such as rules on remuneration, conflicts of interest, risk management, liquidity management, investment in securitisation positions, organisational requirements, rules on valuation; (iii) conditions for the delegation of AIFM functions to third parties; (iv) rules

on [depositories](#) such as their tasks and liability; reporting obligations and leverage calculation; and (v) rules for supervisory cooperation.

Parliament's starting position

The European Parliament adopted a [resolution on shadow banking](#) in November 2012, in which it invited the Commission to 'submit a review of the UCITS framework, with particular focus on the MMF issue, in the first half of 2013, by requiring MMFs either to adopt a variable asset value with a daily evaluation or, if retaining a constant value, to be obliged to apply for a limited-purpose banking licence and be subject to capital and other prudential requirements'.

Preparation of the proposal

In the context of improving the international financial framework and in view of the shortcomings in it demonstrated during the crisis, the [Financial Stability Board](#) and other institutions, such as the [International Organisation of Securities Commissions](#) and the [European Systemic Risk Board](#) (ESRB) have analysed the financial sector and concluded that certain systemically important activities and entities (including MMFs) had not been sufficiently regulated.

In March 2012 the Commission published its [Green Paper on Shadow Banking](#), responses to which helped to prepare a more specific consultation on the investment funds framework, including a part devoted to MMFs ([launched](#) in July 2012). It received 56 responses on the MMF section, mostly from public authorities and the industry and its various stakeholders.

The Commission has also carried out an [impact assessment](#) analysing 16 policy options⁴ against the general objectives (improving financial stability and increasing the protection of MMF investors), and more specific policy objectives (preventing the risk of contagion to the real economy and the sponsor, and lessening the disadvantages for late redeemers, particularly in stressed market conditions). The assessment concluded that a more robust framework for MMFs requires the boosting of liquidity levels and the introduction of a more stable structure. The Commission expects that the impact of the regulation will be beneficial to MMFs by enhancing their resilience to stressed market conditions. This would lead to more stability on the money markets in general that will benefit investors, issuers of short-term debt and banks sponsoring MMFs.

The changes the proposal would bring

On 4 September 2013, the European Commission adopted a [proposal](#) for new rules on MMFs. The proposed [regulation](#) aims to improve the ability of MMFs to weather possible redemption pressure by boosting their liquidity profile as well as stability, to be achieved through five initiatives:

- introducing mandatory conditions on portfolio structure – MMFs would need to hold at least 10% of assets that mature (have to be repaid by the issuer) within a day, and a further 20% that mature within a week;
- establishing a [capital buffer](#) (3% of the assets) for 'constant net asset value' (CNAV) MMFs, which seek to maintain a stable share/unit price (unlike [variable](#) NAV MMFs) – this buffer would be used to help ensure stable redemption prices;⁵
- clear labelling of MMFs, differentiating between short-term and standard kinds; **short-term MMFs**, which may be either VNAV or CNAV, have residual maturity of less than 397 days; **standard MMFs** are allowed to invest in longer-term instruments than short-

term MMFs. Their residual maturity may not exceed two years. Standard MMFs cannot be CNAV;

- customer profiling policies to help predict substantial redemptions;
- internal credit risk assessment by MMF managers, to prevent excessive dependence on external ratings.

The regulation would apply to all MMFs established, managed and/or marketed in the EU and intends to be exhaustive (leaving no room for additional gold-plating⁶ at Member State level). MMFs are defined as either UCITS or AIFs that invest in short-term financial instruments and have specific objectives (such as offering returns and preserving the value of investments).

Consequently, the proposed regulation is intended to supplement present rules. The existing authorisation procedures for UCITS as specified in the UCITS Directive are still valid. The MMF regulation would introduce a harmonised authorisation procedure for AIF MMFs, currently left to the discretion of national authorities (mirroring the authorisation procedure for UCITS). Managers and funds falling under the scope of the new regulation will have to comply with this supplementary layer of MMF-specific requirements as well as either the UCITS or AIFM Directive.

Net Asset Value (NAV) buffer

CNAV MMFs must meet specific additional requirements, most importantly the establishment and maintenance of an NAV buffer to at least 3% of the total value of their assets. It would be applied to cover differences between the MMF's CNAV and market value NAV, in other words to absorb the market fluctuations inherent in capital markets. The buffer would be composed exclusively of cash and held in a protected reserve account separate from the MMF. If this falls below 3% the competent authorities and European Securities and Markets Authority are to be notified. If the MMF fails to replenish the buffer within one month it ceases to be a CNAV MMF. Short-term money market funds that choose not to establish a capital buffer would be required to convert to VNAV pricing.

Advisory committees

The European Economic and Social Committee (EESC) adopted its [opinion](#) in December 2013. The Committee welcomed the proposal and endorsed the choice of legal instrument by the Commission (a regulation rather than a directive), underlining that the global character of MMFs' activities requires uniform and immediately applicable rules. Furthermore, the EESC supported applying the rules for MMFs jointly with the US authorities, given the high degree of market integration. It also strongly recommended that constant net asset value (CNAV) funds are converted into variable net asset value (VNAV) funds, and warned that the 3% capital buffer is likely to be insufficient to cope with liquidity demands at a time of stressed market conditions when many investors may seek redemptions simultaneously (taking into account that in the past there have been cases requiring over 6% of CNAV assets). To counter the possibility of external agencies triggering panic among investors the Committee recommended introducing robust internal rating measures, reinforcing risk management procedures and safeguards and more stringent oversight. Furthermore, to safeguard the stability of the financial system, the EESC argued that the MMF industry should be subject to rules and controls similar to those covering the banking system.

Legislative process

The European Parliament voted its amendments on the proposal for the MMF regulation in plenary on 29 April 2015. In its [amendments](#), the European Parliament recognised that MMFs need to be more resilient to crises. MEPs proposed to remove the obligation to hold a 3% capital buffer for CNAV MMFs and to limit CNAV MMFs to:

- Retail CNAV MMFs, available only for selected investors such as charities, public authorities, and foundations and non-profit organisations;
- Public Debt CNAV MMFs (investing 99.5% of their assets in public debt instruments, and, by 2020, at least 80% of their assets in EU public debt instruments) – a new type of Low Volatility Net Asset Value MMFs (LVNAV MMFs may show a constant NAV under strict conditions). This type of fund would be authorised for a maximum period of five years,⁷ but the Commission would review the regulation after four years, specifically including examination of the possibility of extending this authorisation indefinitely.

All MMFs should have in place [liquidity fees](#) and [redemption gates](#) to help prevent sudden outflows. Public Debt CNAV MMFs and Retail CNAV MMFs should cease to be CNAV MMFs if they fail to meet the minimum amount of weekly liquidity requirements within 30 days of having utilised the liquidity fees or redemption gates. In such instances, they should automatically convert to a VNAV MMF or be liquidated. The Parliament also underlined that it is not appropriate to ban MMFs from soliciting or financing an external credit rating and added financial derivative instruments (fulfilling certain conditions) and high-quality asset backed securities (e.g. car loans) to instruments eligible for investment by MMFs. MMFs will also be required to diversify their asset portfolios, respect strict liquidity and concentration standards, have sound stress-testing processes and increase their reporting and transparency towards investors.

Importantly, the assets of an MMF are to be valued every day and this value published daily on its website. MMFs are also to report weekly to their investors the following: the liquidity profile; the credit profile and portfolio composition; weighted average maturity (WAM) of the portfolio; weighted average life (WAL) of the portfolio; and concentration of the top five investors in the MMF.

The plenary did not conclude Parliament's first reading, instead referring the proposal back to the ECON Committee with a view to starting trilogue negotiations as soon as possible, pending the Council agreeing on its general approach.

Council presidencies have strived to advance the dossier since 2014. A substantial breakthrough came in June 2016 when the Economic and Financial Affairs Council agreed draft rules [negotiated](#) with the EP. That text lays down rules for MMFs, in particular with regard to their portfolios and the valuation of their assets, and introduces common standards to boost their liquidity when market conditions are stressed. In addition, the text provides for common rules to ensure that fund managers have a good understanding of their investors, and provide investors and supervisors with adequate and transparent information. The new rules introduce a permanent category of LVNAV MMFs which are to replace most of the existing CNAV MMFs within two years of entry into force of the regulation. LNAV MMFs would be allowed – although to a limited extent and under strict conditions – to offer a constant net asset value. The CNAV MMFs would be limited to those that invest 99.5% of their assets in public debt instruments and those with an investor base solely outside the EU.

Trilogue meetings started in July 2016. On 7 December 2016, the Permanent Representatives Committee approved, on behalf of the Council, an [agreement](#) with the EP. It clarified the liquidity requirements for funds: LVNAV and CNAV MMFs will need to invest a minimum 10 % portfolio investment in daily maturing assets, and a minimum 30 % portfolio investment in weekly maturing assets. Up to 17.5 % of the minimum liquidity required in weekly maturing assets can be held in public debt instruments. VNAF MMFs will need to place a minimum 7.5 % portfolio investment in daily maturing assets, and a minimum 15 % portfolio investment in weekly maturing assets. Up to 7.5 % of the minimum liquidity required in weekly maturing assets can be held in public debt instruments.

Regarding asset diversification, the [agreed text](#) envisages a 17.5 % limit on investments in other MMFs, and a 15 % limit on reverse repurchase agreements. Furthermore, the text sets specific limits for covered bonds and for deposits in the same credit institution, and introduced an exemption from diversification rules for employee saving schemes. By five years after the entry into force of the MMF Regulation the Commission is required to report on its adequacy as well as on the feasibility of establishing an 80 % EU public debt quota for public debt CNAV MMFs. The latter report is to examine availability of short-term EU public debt instruments, and the possible replacement of non-EU public debt CNAV MMFs by LVNAV MMFs.

The European Parliament approved the [text](#) in April 2017, and in May the General Affairs Council approved the regulation by qualified majority ([Luxembourg](#) voted against). The final act was signed on 14 June 2017, and published in the [Official Journal](#) on 30 June.

Most provisions⁸ will apply from one year after the entry into force of the regulation, i.e. from 21 July 2018.

EP supporting analysis

[Initial appraisal of a European Commission Impact Assessment Money Market Funds](#), European Parliamentary Research Service, European Parliament, PE 514.103, February 2014.

[Money Market Funds – Impact Assessment of Substantive EP Amendments](#), European Parliamentary Research Service, European Parliament, PE 545.547, March 2015.

Other sources

[Money Market Funds](#), European Parliament, Legislative Observatory (OEIL).

[Money Market Funds](#), European Commission, Banking and Finance website.

Endnotes

- ¹ French MMFs are made up almost [entirely](#) of VNAV MMFs, while Luxembourg and Ireland host the [majority](#) of CNAV MMFs.
- ² Despite this concentration in three countries, the market is interconnected to a high degree at EU level through a high proportion of cross-border investments as well as investors, and the cross-border contagion possibility between MMFs and their sponsors.
- ³ The Directive is [complemented](#) by four implementing acts (two Directives and two Regulations). Furthermore, to improve consumer protection in financial services, the EU adopted [Directive 2014/91/EU](#) amending Directive 2009/65/EC.
- ⁴ The [summary](#) of the Impact Assessment reads: 'In order to meet the first operational objective (ensure adequate levels of MMF liquidity), the Commission's services have analysed different policy options covering the following aspects: three different mechanisms of redemption fees or restrictions, one option on liquidity buffer, one option on asset quality and diversification and options on MMF 'customer profiling'. In order to meet the second

operational objective (equip MMF to withstand adverse market conditions), the Commission's services have analysed policy options related to the following aspects: one option on transparency, two options on valuation requiring a floating NAV, two options imposing NAV buffers, one option on bank status, one option combining floating NAV and NAV buffer, and one option on rating.'

- ⁵ The American phrase '[breaking the buck](#)' originates from MMFs. In the USA, MMFs traditionally keep the net asset value at US\$1. If the value drops below the \$1 NAV level, some of the original investment is depleted and investors will lose money.
- ⁶ The Commission defines [gold-plating](#) as 'transposition of EU legislation, which goes beyond what is required by that legislation, while staying within legality. Member States have large discretion when implementing EU directives. They may increase reporting obligations, add procedural requirements, or apply more rigorous penalty regimes. If not illegal, "gold-plating" is usually presented as a bad practice because it imposes costs that could have been avoided.'
- ⁷ This provision is called, by many stakeholders, a 'sunset clause'. It is [defined](#) as: 'A statutory provision providing that a particular agency, benefit, or law will expire on a particular date, unless it is reauthorised by the legislature'.
- ⁸ With the exception of Article 11(4), Article 15(7), Article 22 and Article 37(4), which apply from 20 July 2017.

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