THE FLAWS WITH FLOATING

FORCING MONEY MARKET FUNDS TO CONVERT TO A VARIABLE NET ASSET VALUE WOULD NEGATIVELY IMPACT CORPORATE INVESTORS, SAYS JONATHAN CURRY

Thanks to the global financial crisis, money market funds (MMFs) have been thrust into the spotlight. Although they are generally viewed as very secure investments, European regulators fear that in a period of stress they could be vulnerable to a run if investors start redeeming their funds in a hurry. This, in turn, could prove a systemic risk since MMFs can be large. The biggest MMF in Europe had more than €50bn of assets under management as of 4 September 2013, according to the European Commission*.

Needless to say, the scrutiny that MMFs are under is a mixed blessing for corporates. While they should benefit from safer financial markets, regulatory proposals for MMFs threaten some of the features of the funds that corporates value most, namely their focus on capital preservation and liquidity.

Where are we now?

In September 2013, the European Commission published a set of proposals intended to help MMFs "better withstand redemption pressure in stressed market conditions by enhancing their liquidity profile and stability". There are 44 proposals in total, which address both structural and investment risk. The most significant structural changes include:

- MMFs with a constant net asset value (CNAV) would be compelled to convert to a floating or variable net asset value (VNAV) or hold a 3% capital buffer (to be built up over three years at a rate of 1% per year). The Commission believes this will address the run risk in stressed market conditions.
- MMFs would be prohibited from paying for, or soliciting, a credit rating for the fund from a credit rating agency.
- Support from sponsors would be prohibited unless approved by the appropriate regulator on the grounds that it believes the support will reduce systemic risk. The Commission's logic for this is that if a sponsor supports an MMF, this support creates stress on its own financial position, putting it at risk, ie it is a systemic risk issue.

Turning to investment risk, the most important reform proposed is the introduction of minimum liquidity requirements for funds so that they are able to satisfy investor redemptions. 'Short-term' MMFs would be obliged to hold at least 10% of their assets in instruments that mature on a daily basis and an additional 20% of assets that mature within a week.

The good and the bad

Many of the Commission's proposals are prudent reforms. These include the prohibition on sponsor support and the minimum liquidity requirement mentioned above, as well as the requirement for stress testing and a greater focus on transparency. The make-up of the client base of an MMF is important, too, which is why the emphasis on 'know-your-client' policies and client-concentration policies is sensible. Equally, the MMFs

IMPLICATIONS FOR INVESTORS

Assuming there is a conversion to VNAV – and this is not definite – what are the implications for current investors in CNAV MMFs?
Firstly, they need to understand the likely level of volatility in the yield of the fund. It will be hard for them to take a view as to whether a VNAV MMF will be a valuable investment tool going forwards without knowing what that volatility will be.

It is not clear under the new proposals whether MMFs could still be classified as cash and cash equivalents from an accounting perspective. But a precedent does exist in France where VNAV funds are considered cash and cash equivalents. Certainly, if you look at the accounting definition of 'cash and cash equivalent', it is possible to argue that a VNAV fund should be classified in this way.

Tax treatment is a consideration. In CNAV funds that use distributing share classes, the money that is accumulated is classified as income. In a VNAV world, will there be gains and losses, as well as income, to be considered from a tax point of view?

Many investment policies stipulate that it is only CNAV funds that investors can invest in, so these policies would need to be revised.

If the proposal to ban MMFs from paying for, or soliciting, a credit rating is included in the final regulation, it could present difficulties for investors whose investment policies stipulate that they must use rated funds.

Investors will need to consider whether their treasury systems can accommodate the floating price of a fund.

must be able to treat their shareholders fairly in a period of market stress. So a good safeguard is the proposed introduction of a liquidity fee on redeeming shareholders during periods of severe market stress.

Some of the other proposals are more concerning, however. The Commission's assumption that CNAV funds are more vulnerable to an investor run than VNAV funds is a red herring and appears to be based on theory rather than facts. Evidence from the crisis suggests that there is no differentiation between funds' sensitivity to runs simply based on their accounting.

Meanwhile, the proposed capital buffer is unlikely to achieve its aims. The reason why investors may redeem from MMFs during periods of severe stress is that they have a concern over some, or all, of the assets that an MMF holds. In that scenario, a 3% capital buffer will not be effective in reducing the risk of a run. In addition, it brings into question the economics of running an MMF, as well as the attractiveness of MMFs to investors.

There are also proposals to restrict the use of amortised cost accounting. But amortised accounting is valuable given the type of assets that MMFs own and the difficulties that exist in sourcing pricing for those assets. There is a limited two-way market in assets that MMFs purchase.

What's happening next?

Besides the European Commission, there are two other important constituents in the debate. These are the European Parliament and the European Council. The European Parliament needs to come up with its own view of MMF reform, based on consideration of the Commission's proposals. It began debating the subject in the last quarter of 2013, but in March it decided to defer a decision until the next parliament, which will open after elections in May. The European Council, which comprises the heads of government of the EU member states, also needs to consider the Commission's proposals and come up with its stance on them. The Council has not yet begun its deliberations, however. That may occur in the second half of this year, but there is no certainty it will take place in 2014.

Once all three protagonists have reached their conclusion, a trilogue will take place where the parties will discuss their views and come up with a final set of reform recommendations. So the very earliest we could see regulation enacted in law is likely to be in late 2015.

There is another factor that could influence the time frame for reform. The transition period for MMF providers, investors and suppliers to adapt to the new regulation is currently set at six months. But if that is extended, the question is how long would it be extended for? It may be for 12 months, but, potentially, it could be for longer than that.

Looking to the future

So what will the world look like if MMFs are forced to convert to VNAV? We may see the emergence of MMFs with varying risk, return and volatility profiles. This will present different options for investors that are sensitive to volatility. Fortunately, it is still early in the debate on MMFs, and it is by no means certain that we will even end up in a VNAV world.

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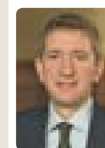
*SOURCE: EUROPEAN COMMISSION – MEMO/13/764 04/09/2013



Jonathan Curry is global chief investment officer – liquidity at HSBC Global Asset Management