WHAT'S NEXT FOR YOUR NEST EGGS?

FOLLOWING THE FINANCIAL CRISIS, REGULATORS HAVE BECOME NERVOUS OF MONEY MARKET FUNDS. SUSAN HINDLE BARONE EXPLAINS WHAT THIS WILL MEAN FOR MMF INVESTORS IN THE FUTURE

Generally speaking, money market funds (MMFs) are a pretty innocuous product. A group of investors come together to pool their interests and invest in very simple debt instruments. They will buy only high-quality assets and they can't buy anything with a maturity of longer than 13 months. They do not use leverage and they employ credit analysts who first assess what is a suitable credit and then continue to monitor those credits over time.

The scale of the funds also leads to another important benefit – that of deeper liquidity. An individual treasurer managing working capital and surplus cash independently, who needs to maintain immediate access to the majority of the company's funds, is restricted to a very short time horizon and so is limited in the return that the company can earn. But by investing collectively, companies benefit from liquidity contributed by others and from the knowledge that they are all unlikely to need to call on that money at the same time.

So why did an apparently simple and harmless product get dragged into the shadow banking debate?

At least part of the answer lies in the success that MMFs have enjoyed. Although MMFs are conservative and cautious, they are also fairly large. Before the global financial crisis, the combined size of the US and European MMF industry was approximately $3.6 trillion. The larger part of this market was based in the US, where the product had been established longer, but the European market had grown strongly over the preceding decade.

Impact of the crisis

The global financial crisis has impacted MMF investors in two significant ways. Firstly, treasurers' experience of what happened to some banks (but not to others) has highlighted why it is a good idea to have your risk spread over perhaps 50 largely uncorrelated credits rather than deposited with five banks, all of whom know each other. Secondly, following the crisis, a corporate's confidence about being able to borrow cash at short notice – either directly from the capital markets or via a loan or extended overdraft from a bank – is much reduced. Commercial enterprises of all kinds are carrying more cash. And it needs to be stored somewhere – ideally not all on deposit, exposed to single-name bank risk. So the demand for MMFs in Europe is even higher now than it was pre-crisis.

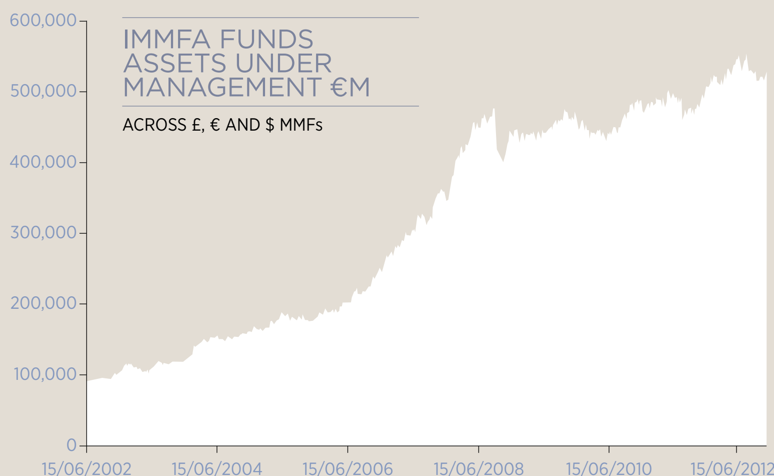
Regulators agree that MMFs in no way caused the crisis. It could be argued, however, that the desire to harness a portion of the cash invested in MMFs contributed, along with other oversights and supervisory shortcomings, to some behaviour that ultimately led to the global meltdown.

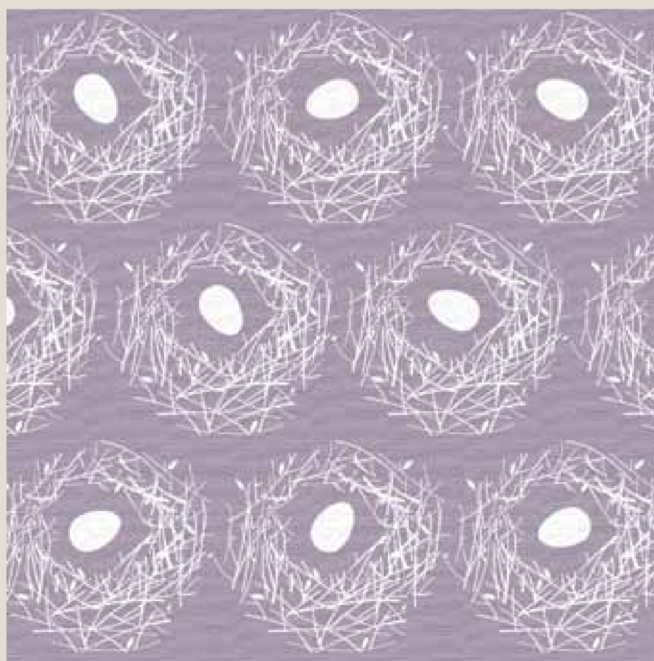
The sheer scale of MMFs concerns regulators. What would happen to the institutions that an MMF has invested in if the fund decides, for whatever reason and no matter how reasonably, to withdraw its funding?

They also worry about the links between MMFs and the banking system. For example, many sponsors of MMFs are banks. Regulators see a parallel with the obligations that the banks (and their supervisors) suddenly found they had in relation to their asset-backed commercial paper conduits and structured investment vehicles. They seem to forget that those were largely contractual undertakings to provide liquidity, whereas MMFs are stand-alone mutual funds.

Furthermore, many MMFs invest in short-term bank debt, though to a much lesser extent than has previously been suggested. A recent report by rating agency Fitch stated that on average European banks rely on European constant net asset value (CNAV) MMFs for approximately 1% of their deposits and short-term funding.

The Institutional Money Market Funds Association (IMMFA) would argue that many of these specific concerns





regarding the interrelation between banks and MMFs would be better addressed directly in banking legislation rather than by putting restrictions on MMFs.

Strengthening MMFs

The MMF industry has introduced additional protection to ensure that it is better prepared for any future market disruption. In Europe, the European Securities and Markets Authority (ESMA) guidelines were introduced with the aim of harmonising MMFs into two defined risk categories. Many asset management firms in Europe believed that this didn't go far enough, however. In the US, Rule 2a-7 of the Investment Company Act, which determines how US MMFs operate, brought comprehensive changes in 2011 – for example, it specified tighter credit limits for a fund and the minimum levels of liquidity that a fund needs to maintain.

These changes are intended to make funds more self-contained – and less dependent on the market should conditions become difficult – while still being able to repay investors when they want to take money out.

IMMFA funds all meet the ESMA guidelines for short-term MMFs. In addition, they voluntarily adhere to the IMMFA *Code of Practice*, which bears many similarities to Rule 2a-7.

So, what next?

Many regulatory and supervisory bodies have joined the debate over the future of MMF regulation – with varying degrees of consultation and understanding. Here in Europe, the European Commission will propose new legislation for MMFs and by the time you read this article, they may have already done so.

The US is working independently to propose new MMF legislation. But although alignment with European regulation may be beneficial for the MMF industry and its investors, there is no guarantee that the same or similar solutions will be proposed.

Possible solutions

The following proposals for further MMF reform have been discussed:

◆ **Prescribed liquidity**
This entails specifying the amount of assets that will mature in certain timeframes – currently 'next day' and 'within one week' intervals are applied. Already used in the US and voluntarily in Europe by IMMFA funds, it is welcomed and likely to be adopted more widely.

◆ **Enhanced disclosure and reporting**
Increased transparency is widely viewed as desirable. Enhanced reporting should ensure that the regulatory authorities are more aware of what happens in MMFs. But few regulators believe that this alone would be a sufficient remedy.

◆ **Capital buffers**
This is an amount of capital to be held by the fund to make good any losses in the fund. The levels that are rumoured to be under consideration (around 3%) would render MMFs uneconomic to providers and/or users.

◆ **Know your client**
A fund is much less vulnerable if there is a lower likelihood of large numbers of investors needing to withdraw funds at the same time. Funds should aim for a more diverse investor base as well as a diverse asset base. Regulators don't view this as a priority at present.

◆ **CNAV and VNAV**
The most bitter part of the debate. CNAV and variable net asset value (VNAV) are different ways of representing the price of shares in a fund and amount largely to a technical accounting difference. Regulators seem to think that investors are more likely to flee from a CNAV fund than from a VNAV fund, in a stressed market. CNAV providers argue that investors are sensitive to the risk being carried in a fund – not its accounting technique. A mandatory conversion from CNAV to VNAV would be an accounting and operational inconvenience to many investors and in some cases would make an MMF unusable. Moreover, it would not have changed the fund's systemic risk profile.

◆ **Redemption gates and/or liquidity fees**
These features are already present in many of the CNAV MMFs offered in Europe. IMMFA believes they are the most effective way of dampening volatility in a stressed market situation, by enabling the manager to perform its fiduciary responsibility.

Impact on investors

Investors know that it often makes sense to store cash in funds where they benefit from a widely diversified portfolio, expert credit analysis and pooled liquidity. But despite the best efforts of many market participants to explain the shortcomings of some of the more potentially disruptive regulatory proposals, changes are likely to be made that impact investors.

We encourage all MMF investors to familiarise themselves with the issues and to make their voices heard if they wish to be part of the debate. This can be done via the ACT, IMMFA, through your MMF providers or directly with your MEPs, HM Treasury, etc. It is not too late to influence the outcome of this debate.

Note: IMMFA will be hosting a session at the ACT conference in Liverpool when we will be able to update you on the latest developments in the discussions around MMFs.

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