25 July 2023

Better late than never: European Commission constructive on money market funds

Summary

- One year after it was due, the European Commission has published its long-awaited assessment report on the functioning of the European money market fund (MMF) regulation.
- The report concludes the regulation works: MMFs "passed" the recent market stress events. This means the existing safeguards in the regulation, including the existing fund types, work.
- This augurs well for the continued viability of the low volatility net asset value (LVNAV) MMF type.
- The report also supports de-linking redemption gates and liquidity fees from weekly liquid assets, removing a key investor sensitivity.
- We remain of the view reforms are unlikely in the current European parliamentary term (to 2024). However, the publication of the report is an important step forwards in the reform process.

The main conclusions

The overall tone of the European Commission's assessment report is constructive. The report finds the MMF regulation enacted in 2017 largely worked, successfully navigating several periods of market stress since implementation. The review takes into consideration both the stress period of March 2020 (particularly acute for US dollar MMFs) and September 2022 (acute for sterling MMFs[1]). In our view the report speaks to continuity of the current regulatory framework – and current fund structures - rather than wholesale change.

"The report is overall balanced, identifying, on one hand, some issues which should be addressed and, on the other, highlighting the regulation made European MMFs resilient and able to successfully navigate several periods of extreme market stress."

[1] See: Lessons on volatility for money market investors - Aviva Investors

Demi Angelaki, senior portfolio manager, Aviva Investors

The most important change proposed is the removal of the link between weekly liquid assets and LVNAVs needing to apply a redemption gate or liquidity fee. As it currently stands, an LVNAV must consider applying a gate (temporary suspension of redemptions) or liquidity fee (charged to exiting investors) if weekly liquid assets fall below 30 per cent and the fund experiences a same day net outflow of over ten per cent.

Ultimately the fund's board of directors decides on the most appropriate course of action – the link is not automatic. Investors have nonetheless been concerned funds could impose a gate as a result. The report voicing support for removing this link is a clear positive for investors because of the uncertainty resulting from the current set-up. Although it is worthwhile pointing out no European MMF has ever suspended redemptions under the current regulation and the protections against this outcome are high.

The report also considers pricing. It judges amortised cost pricing is appropriate in certain circumstances for LVNAVs and constant net asset value (CNAV) MMFs. With amortised cost pricing enabled, this suggests there is some support at the European Commission for LVNAVs continuing to be able to offer stable pricing. Other European bodies have argued against this, however (see below).

Lastly, the report makes two potentially significant additional observations. First, it suggests allowing MMFs to access deposit facilities with central banks. This would be like the structure in the US in which MMFs can enter overnight reverse repurchase agreements with the Federal Reserve. This facility has been actively and successfully used by US MMFs. In stressed market conditions, access to such a facility should be highly positive for MMFs.

"This would take the pressure off around the pinch points of month end, quarter end and, in particular, year-end, when banks restrict the amount of cash they take in the short dates. If the new regulation increases the short-dated investments a fund is required to hold, a facility like this would help funds negotiate the month-end restriction."

Richard Hallett, head of UK liquidity portfolio management, Aviva Investors

Secondly, the report calls for a review of the functioning of the short-term market more broadly, recognising MMFs are creatures of their environment. Rule changes just for MMFs will not necessarily be as effective as they could be if not accompanied by changes to the environment in which they operate.

A good example of market functioning is the settlement cycle of commercial paper (CP). In the US, funds buy overnight CP that settles T+0 as well as using the Fed reverse repo facility and term deposits. In contrast, the T+2 settlement cycle typical in Europe means overnight CP is not widely used. Secondary market liquidity also needs to be looked at as there is an overreliance on bank balance sheets, which can, in times of stress, be reduced.

You can access the EC report, here.

The legislative cycle is the key determinant of reform timing

The assessment report is a material step forwards for the reform process in Europe. But it is only a diagnostic report. Actual reforms remain some way off. We remain[2] of the view final reforms are unlikely in the term of the current European parliament (until June 2024), but the likelihood is evidently greater than it was before the report was published.

The relevant European bodies - the Commission, Parliament and Presidency - will now need to formalise their respective positions on MMF reform. The Commission's report will clearly feature in the determination of positions, as will the views aired by the European Securities and Markets Association (ESMA) and European Systemic Risk Board (ESRB). International activity, such as the recently enacted reforms in the US, will also play a role, at least as a reference point.

Having reached their respective positions, the "trialogue" process will begin, whereby the Parliament, Commission, and Council of the EU (Spain has the rotating presidency until December 2023, followed by Belgium) negotiate and agree a final position. This is, ultimately, a political process. There are, therefore, significant uncertainties as to the final agreement.

The time available to finalise positions and complete the trialogue process is short and decreasing rapidly. The current European Parliament's term is coming to an end. Elections will take place from June 6 to 9 next year[3]. Attention will increasingly turn to the candidates and their policies as the elections approach, decreasing the likelihood of major policy decisions. Simultaneously, the desire to push decisions to the next elected body will increase. All European politicians face re-election, and will subsequently need to agree the new EU Commission president (currently Ursula von Leyen, Germany).

We also have the summer holidays with which to contend. The European governmental summer recess has now begun following the last plenary session of the European Parliament on July 13, with no more sessions until September[4].

Putting all this together, there is little time to agree final policy in the current political term. That said, the fact the US published reforms for US MMFs recently (in July 2023, see below) will increase pressure on Europe to act.

Past precedent suggests there will be an implementation period once the reforms are signed into law. The last set of reforms had an 18-month implementation period. In the US, the most recent set of reforms have an implementation period of just 60 days.

[2] European MMF Reform: Preparing for change - Aviva Investors
[3] Council confirms 6 to 9 June 2024 as dates for next European Parliament elections - Consilium (europa.eu)
[4] Parliament adopts its calendar for 2023 | News | European Parliament (europa.eu)

Comparing the assessment report with existing policy proposals

The purpose of the report was not to provide policy proposals. Therefore, the comparison with the actual proposals from ESMA and the ESRB is not entirely valid. Nonetheless, it provides some reference points.

Firstly, the European Commission is clear much of the existing regulation is working. This contrasts with both ESMA and the ESRB, which propose meaningful changes. The European Commission is silent on the future of LVNAV, but clear existing safeguards (including the use of amortised cost) are working. On the other hand, ESMA and the ESRB propose changes of such magnitude to the LVNAV structure that it would, frankly, become untenable.

The European Commission recognises changes to LVNAVs would have wide-ranging implications for investors. Indeed, ESMA's 2021 survey of the European MMF industry (the most recent official numbers) showed 46 per cent of the industry was LVNAVs at end-2021, followed by VNAVs (short-term and standard) at 42 per cent[5].

The ESRB published policy proposals in January 2022[6] and ESMA a month later[7]. At an international level, the Financial Stability Board (FSB) published policy proposals in 2021[8], broadly supporting the need for the removal of threshold effects (aka delinking gates and fees from weekly liquidity), increased liquidity and liquidity management tools (LMTs, among other points).

[5] ESMA report finds EU MMF industry at close to €1.5tn (europa.eu)
[6] ESRB recommends increasing the resilience of money market funds (europa.eu)
[7] ESMA proposes reforms to improve resilience of Money Market Funds (europa.eu)
[8] Policy proposals to enhance money market fund resilience: Final report - Financial Stability Board (fsb.org)

What do the policy recommendations say?			
Policy Recommendation	EC	ESRB	ESMA
LVNAVs	The safeguards in the MMF regulation have been working as intended. Amortised cost can continue.	Relevant Union legislation should require all LVNAV MMFs to have a fluctuating NAV.	Removing the possibility to use amortised costs for LVNAVs.
Gates and fees	Should decouple the potential activation of liquidity management tools from regulatory liquidity thresholds.	The repeal of the regulatory thresholds set out in Article 34(1)(a) and (b) of Regulation (EU) 2017/1131 (*i.e. provisions regarding gates and fees*).	Decoupling regulatory thresholds from suspensions/gates/redemption fees for LVNAVs.
Liquidity management tools	Should be considered in line with the review of other mutual fund regulation (which also covers MMFs).	Should require the incorporation in the constitutional documents of MMFs and any other pre-contractual information of at least one LMT.	Mandatory availability of at least one LMT for all MMFs; activation of these by the manager of the MMF.
Liquid asset availability	Increases may have unintended consequences.	Should incorporate new liquidity requirements for variable net asset value (VNAV) and LVNAV MMFs, composed of daily liquid assets (DLA), weekly liquid assets (WLA) and public debt assets.	Amendments of the DLA/ WLA of VNAV (and LVNAV) MMFs, as well as the pool of eligible assets, including public debt assets, which can be used to satisfy these liquidity ratios.
Source: EC, ESMA, ESRB, Aviva Investors, July 2023. For full details please access the policy documents themselves.			

Meanwhile, over in the US

The SEC published reforms for US onshore MMFs recently. The changes are material, but equally, allow continuation of the industry more or less as is. While Europe and the US will undoubtedly chart their own courses, the decisions made in the US may well factor into the thinking in Europe, not least given the sheer size of the US market (over $5 trillion at the end of June[9]).

- Liquidity increases: Minimum level of liquid assets increases to 25 per cent daily and 50 per cent weekly for prime[10] funds, from ten per cent and 30 per cent respectively. All else being equal, a higher liquidity requirement will imply lower yields.
- Gates and fees removed: US MMFs will no longer be able to temporarily suspend redemptions, nor will there be any tie between the level of weekly liquid assets and liquidity fees. This was a key issue for many investors because they were concerned that if liquidity fell below the required threshold, the fund would have to suspend redemptions. The removal of this link is positive and may well lead to investors allocating more to prime funds.
- Liquidity fees: A new provision requires institutional funds to charge liquidity fees when net daily redemptions exceed five per cent of total assets. There is some optionality around this, however.
- Short implementation timeframe: Most of the reforms will become effective 60 days after the rules are published in the Federal Register. Some reporting requirements will not become effective for almost a year, however. This implementation timeframe is materially shorter than the two-year implementation time at the last round of reform.

These reforms were broadly expected. Importantly for both the industry and investors, two items did not make the final rule set:

- No swing pricing: There had been considerable debate in the run-up to the reforms on swing pricing (where a fund's price varies depending on the cost of subscriptions and redemptions). Industry participants viewed swing pricing as unworkable for MMFs as it would have effectively precluded daily dealing.
- Constant pricing remains for government and Treasury funds. There had been discussion of all funds moving to variable pricing, but the new rules allow government and Treasury funds to continue offering stable pricing. As a reminder, all US prime funds were forced to move to variable pricing in 2016, when the 2014 reforms became effective.

You can access the reforms on the SEC's website, here.

[9] Weekly Money Market Fund Assets | Investment Company Institute (ici.org)
[10] Prime funds are similar to European LVNAVs in that they typically invest in high credit quality bank and corporate securities (as well as Government securities) but differ in that they can *only* operate with a varying net asset value per share.

Conclusion: Watch this space!

The publication of the European Commission's assessment report is a significant step forward in the European MMF reform process. In combination with the recent publication of final reforms by the US, the pressure on Europe to act is growing. However, the near-term timetable counts against progress being achievable near-term. We can't rule out an agreement on European MMF reform being agreed in this European Parliament, but the clock is ticking. Even if reforms can be agreed, we would anticipate an implementation period, meaning investors will have time to react. The broadly constructive tone of the European Commission's diagnostic report augurs well for the status quo and, importantly, the continuation of the LVNAV fund type. However, the political process still has some way to go.
We will update our investors as new information comes available.

Key Risks

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.
The Fund invests in money market instruments such as short term bank debt the market prices/value of which can rise as well as fall on a daily basis. Their values are affected by changes in interest rates, inflation and any decline in creditworthiness of the issuer.
This is not a guaranteed investment, an investment in a Money Market Fund is different from an investment in deposits and can fluctuate in price meaning you may not get back the original amount you invested. This investment does not rely on external support for guaranteeing liquidity or stabilising the NAV per unit or share. The risk of loss of the principal is to be borne by the investor.

462650 - 25/07/2024