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EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

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

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1. INTRODUCTION

In Europe, Money Market Funds (MMFs) serve as an important source of short-term financing for financial institutions, corporates and governments. Around 22% of short-term debt securities issued either by governments or by the corporate sector in Europe are held by MMFs. MMF hold 38% of the short-term debt issued by the EU banking sector[1]. On the demand side, MMFs provide a short-term cash management tool that provides a high degree of liquidity, diversification, stability of value as well as market-based yield. MMFs are mainly used by corporations seeking to invest their excess cash for a short time frame, for example until a major expenditure, such as the payroll, is due. MMF, therefore, more than any other investment fund, represent a crucial link bringing together demand and offer of short-term money.

With assets under management of around 1’000 billion Euros, MMFs represent a category of funds distinct from all other mutual funds. The majority of MMFs, 80% in terms of assets and 60% in terms of number of funds, operate under the rules of the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS). The average size of a MMF by far exceeds the average size of a UCITS fund. For example, an individual MMF can reach the size of € 50 billion.

The systemic implications of MMFs, their interconnectedness to the issuers and to their bank sponsors, have been at the core of the international work on shadow banking. The Financial Stability Board (FSB) and other institutions, such as International Organization of Securities Commissions (IOSCO) and European Systemic Risk Board (ESRB) have analysed MMF and their systemic implications. MMFs, especially those MMFs that maintain a stable share price, have been singled out because of their deposit like features.

2. PROBLEM DEFINITION

MMFs represent a convenient tool for investors because they offer features analogous to bank deposits: instantaneous access to liquidity and stability of value. Investors view MMF as a safe and more diversified alternative to bank deposits. But in reality the MMFs are nothing more than classic investment funds with the inherent risks attached to the investments. Therefore when the prices of the assets in which the MMFs are invested in start to decrease, especially during stressed market situations, the MMF cannot always maintain the promise to redeem immediately and to preserve the value of the unit or share issued by the MMF to investors. Some funds may be able to ‘prop up’ share values by granting sponsor support, while others may not have the capital to do so. The downside is that investors, as soon as they perceive a risk that the MMFs may fail to live up the promise of liquidity and stable redemptions at any time, will redeem, possibly leading to a so-called "run".

Investor runs are characterized by massive and sudden redemption requests by a large group of investors that want to avoid losses and be able to redeem at the highest possible price. Investor runs are systemically relevant as they force the MMFs to sell their assets rapidly in order to meet outstanding redemption requests. The spiral of redemptions itself

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[1] In France, MMFs hold 45% of certificates of deposit issued by banks and 35% of certificates issued by non-financial corporations.

accelerates the decline in the fund's net asset value (NAV), thus exacerbating declines in the NAV and the fear that the money market as a whole is unstable.

The problems linked to investor runs are of a systemic nature due to: (1) MMFs close links to the real economy, (2) their link to sponsors. In addition, runs on MMF also have an investor protection angle, since those that redeem late are at an inherent disadvantage when compared to early redeemers.

The MMF market is concentrated in a few Member states with FR, IE and LU representing more than 95% of the market in terms of assets under management. The market is nevertheless highly interconnected with other countries due to the high proportion of cross border investments and investors, and the cross border contagion links between the MMF and their sponsor domiciled in other countries.

Contagion to the real economy

During the crisis, liquidity of MMF has not been sufficient to satisfy all redemption requests. This led some funds to suspend redemptions or to use other restrictions. Depriving investors of short-term MMF investments may have repercussions on issuers that rely on short-term finance through MMF. Because MMFs play a central role in the short term funding of entities like banks, corporates or governments, investor runs on MMFs may cause broader macroeconomic consequences. While banks account for the largest part (85%) of the 1'000 billion EUR issued to MMFs, governments represent a share of around 10% whereas corporates account for roughly 5%. Governments and very large corporates use the money market as a means to obtain short term financing, alongside bank credit lines. Any contagion to the short term funding market could then also represent direct and major difficulties for the financing of the "real economy".

Contagion to sponsors

MMFs, especially those that promise redemption at a stable share price, have historically relied on discretionary sponsor capital to maintain their NAV in times of declining asset values. MMF sponsors may decide to provide support in order to compensate decreases in the NAV of their fund. Sponsors are often forced to support their sponsored MMFs out of fear that their MMF's decreasing NAV, due to the reputational risk, may trigger a panic that could spread into the sponsor other businesses. For bank sponsors, the risk is even more acute because the panic could spread to the bank's retail client base which in turn could lead the bank to default.

During the crisis, several instances of sponsor support were observed.

Sponsors are largely unprepared to face such situations because the "implicit" guarantee is not recorded as an explicit guarantee. No capital reserves are build-up to cover for instances of sponsor support. Therefore, depending on the size of the fund and the extent of redemption pressure, sponsor support may reach proportions that exceed their readily available reserves. The largest providers of MMFs manage over €250 billion of MMF assets worldwide whereas in some cases their readily available cash in their balance sheet amount to only a few hundred millions.

Unfair treatment of investors

In a run, each redemption order causes the price of the fund to decrease because the fund is obliged to sell assets with increasing liquidity costs. This creates a first mover advantage where late redeemers (often retail investors) have to bear the costs associated with early redemptions. There is thus a transfer of money from late redeemers to early redeemers. The cost of the redemption may represent a substantial disadvantage for the late redeemers because the difference before and after the redemption may be substantial.

Consequences

Because the money market and sponsors are systemically relevant, governments may be forced to intervene when the money market is facing a crisis. The US authorities set up a plan to guarantee all the money invested in the MMFs. The public authorities in Europe had also to step in to stop the contagion: Germany passed a law to stabilize the market and Luxembourg announced that it would take all necessary steps needed to stabilize the national MMFs. The different reactions from the European entities were not conducive to enhance the stability of the European market as a whole because this provoked displacements from investor's money to MMFs that benefited from such a guarantee.

The consequences attached to MMF liquidation may be extremely disruptive for the investor since redemptions will remain suspended for a potentially very long period of time and the precise amount recovered in the end will remain uncertain for an equally long time. In the case of corporate users placing their cash in a MMF, a suspension can lead to the inability to perform the planned operational expenditures such as paying salaries.

3. ANALYSIS OF SUBSIDIARITY

National regulatory approaches are inherently limited to the Member State in question. Regulating the product and liquidity profile of a MMF at national level only entails a risk of different products all being sold as MMF. This would create investor confusion and would impede the emergence of a Union wide level playing field for those who offer MMF to either professional or retail investors. Equally, different national approaches concerning the essential characteristics of a MMF would increase the risk of cross-border contagion, especially when issuers and the MMF are located in different Member States.

In addition, as many operators that offer MMFs in Europe are domiciled in Member States other than those where the funds are marketed, the creation of a robust framework is essential to avoid cross-border contagion between a MMF and its sponsor. This is especially acute when the sponsor is located in a Member State that may not have the budgetary resources to bail out a defaulting sponsor. As MMF are predominantly domiciled in two EU jurisdictions (IE and LUX), both jurisdictions in which no sponsor banks are domiciled, the cross-border dimension of sponsor support becomes acute.

Therefore, action at European level is needed.

4. OBJECTIVES

The general objectives are to:

(1) Enhance financial stability in the internal market;

(2) Increase the protection of MMF investors

Reaching these general objectives requires the realisation of the following more specific policy objectives:

(1) Prevent risk of contagion to the real economy;

(2) Prevent risk of contagion to the sponsor;

(3) Reduce the disadvantages for late redeemers, especially with respect to redemptions in stressed market conditions.

The specific objectives listed above require the attainment of the following operational objective:

(1) Ensure that the liquidity of the fund is adequate to face investor's redemption requests;

(2) Transform the structure of MMF so that the stability promise can withstand adverse market conditions.

5. POLICY OPTIONS

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.

6. ASSESSMENT OF THE IMPACTS OF THE RETAINED OPTIONS

Operational objective 1: options aimed at increasing the liquidity "know your clients" are the retained options

To ensure that the liquidity of the fund is adequate to face investor's redemption requests, the options to increase the liquidity of portfolio assets and the implementation of a "know your customers" policy score the highest. The three options based on imposing redemption fees or restrictions would, on the other hand, radically decrease the attractiveness of the MMFs for investors. The consultation shows that such options could, in turn, lead to a contraction in the total assets under management of the MMFs, which would deprive the real economy of an important short-term financing tool. In addition these options restricting the redemption possibilities raise issues as regards their possible counter-cyclical effect, which would not diminish the systemic risk but increase it.

By increasing the liquidity of the portfolio and at the same time ensuring that the portfolio is sufficiently diversified and not invested in low quality assets, the objective of enhancing MMF's ability to deal with redemptions is better fulfilled. On the one hand the investors will profit from a better access to the liquidity and from a decreased risk and on the other hand this will increase the ability of the fund to face large redemption requests. The costs of these options appear relatively modest because the majority of the MMFs have already developped internal rules that already go into that direction. The consequences on the short term debt market appear also manageable because only a very small proportion of the assets are invested at the long end of the short term yield curve. The policy to anticipate large redemption requests will not in itself prevent massive runs but still represent a useful tool to manage inflows and outflows and can be implemented at little cost.

Operational objective 2: options aimed at increasing the transparency, ensuring stable valuations and limiting the use of ratings are the retained options

In general all options analysed would increase, at different degrees, the financial stability but none of the options would achieve these results without negative impacts. The retained options are the ones that strike the best balance between financial stability and costs.

Reforming the valuation methodology will restore the evident truth that MMFs are normal mutual funds subject to price fluctuations. The use of amortized cost and rounding method permits the fund to maintain a stable price. Requiring the use of mark to marked valuation will clearly indicate to investors that they bear the risk of their investments, not the sponsor of the fund. This will reduce or even remove the incentive for the sponsor to provide support. The contagion channel to the sponsors, the banking system, would be reduced. Floating the NAV is therefore the option that rates the highest in stabilising the MMF sector and, in turn, limiting contagion to the banking sector. But it cannot be excluded that certain investors may not wish to invest in fluctuating MMFs, which could ultimately lead to a contraction of the MMF sector. The impacts on the managers appear more limited.

As there remains some doubt as to whether all MMF investors will adapt to a floating NAV structure, a MMF provider will have the possibility to maintain a stable NAV fund. But a stable NAV MMF would need to benefit from an appropriate NAV buffer, to be financed by the manager. With the option combining both a floating NAV and NAV buffer, the manager of stable MMFs will have to finance a buffer amounting at least to 3% of the MMF assets under management. According to the observed events of sponsor supports during the crisis (123 instances on US MMFs), only 3 times the support was higher than 3%. When the Reserve Primary Fund defaulted in 2008, it lost 3% on 1.5% exposure to Lehman assets. The buffer will not provide a full guarantee to the holders of CNAV MMFs but this level strikes the balance between the need to have a robust and safe CNAV model and the financing capacities of the managers.

While the floating NAV option has the merit to address the systemic risks in a very effective and simple way, the option combining the two systems acknowledges the fact that it may be disruptive to the overall financing of the European economy if all MMFs were obliged to float their NAV.

Even if a stable NAV with appropriate NAV buffers is a 'second-best' alternative to a floating NAV, the above mentioned combination of both options, under tight conditions, can be recommended in order to ensure that the general policy of floating the NAV will not cause undue disruption to the overall short-term financing of the European economy.

To be transparent about the method chosen, managers will have to increase their transparency toward investors. The issue of massive runs following a downgrade of the credit rating can only be addressed by limiting the use of ratings, at least at the level of the fund.

Impact on third countries

The work surrounding shadow banking is international. The recommendations of IOSCO on MMF, as well as their endorsement by the FSB, require implementation in each G20 jurisdiction. It is particularly important to ensure that the envisaged reforms concerning the liquidity and stability of MMF are applied in a uniform manner, in order to avoid regulatory arbitrage and cross-jurisdictional contagion. Therefore the options retained in this impact assessment reflect the recommendations of IOSCO and the FSB.

The US, as the largest MMF market in the world, requires special attention. Both MMF markets, in Europe and in the US, are interconnected. US based MMFs are important investors in money market instruments issued in Europe. Inversely EU MMFs are important investors in money market instruments issued in the US. As such MMFs on both sides of the Atlantic represent an important financing source not only for corporate issuers and banks in their own Continent but for those entities in the other Continent as well. The US authorities are also engaged in a process of MMF reform. Close dialogue with the US has been established in order to align the subsequent phases of rulemaking.

7. MONITORING AND EVALUATION

Ex-post evaluation of all new legislative measures is a priority for the Commission. The forthcoming Regulation will also be subject to a complete evaluation in order to assess, among other things, how effective and efficient it has been in terms of achieving the objectives presented in this report and to decide whether new measures or amendments are needed.

In terms of indicators and sources of information that could be used during the evaluation, data from different sources will be used. This will be used to monitor the liquidity level, the types of assets, the issuers of the assets and the investors of the MMFs. Based on these indicators it will be possible to draw conclusions regarding the impacts of the reform on financial stability.