

ESRB recommendation on money market funds

On 18 February 2013 the European Systemic Risk Board (ESRB) issued a [recommendation](#) on money market funds¹ (MMFs), which will inform the EU Commissions expected legislative proposals on MMFs. The recommendation sets out objectives to be achieved in such legislative proposals (allowing for the principle of proportionality). The annex to the recommendation (44 pages) is interesting and details recent initiatives on MMFs, issues of concern, analysis of the EU MMF industry, as well as the rationale and further detail on the recommendations. The recommendations cover a variety of issues, but of particular interest are those set out below.

Mandatory move to variable net asset value and restricted use of amortised cost accounting:

- MMFs will be obliged to have a fluctuating net asset value.
- MMFs will be obliged to make general use of fair valuation and to restrict the use of amortised cost accounting to a limited number of predefined circumstances.

Liquidity

- MMFs will be obliged to hold explicit minimum amounts of daily and weekly liquid assets (this will complement the existing liquidity requirements for MMFs).
- MMF managers' responsibility regarding the monitoring of liquidity risk will be enhanced.
- MMF managers will be obliged to put effective tools in place (such as temporary suspensions of redemptions) to deal with liquidity constraints in times of stress resulting from both fund-specific and market-wide developments.

Public disclosure

- MMFs will be obliged to make specific disclosure by MMFs, which draws the attention of investors to the absence of a capital guarantee and the possibility of principal loss. (Irish MMFs are already required to include a risk warning drawing attention to the difference between the nature of a deposit and the nature of an investment in a MMF with particular reference to the risk that the principal invested in a MMF is capable of fluctuation).
- MMFs will be obliged to only refer in their public disclosures to possible sponsor support, capacity for support or protection if that support or protection is a firm commitment by the sponsor, in which case it must be recognised in that sponsor's accounts and prudential requirements.
- MMFs will be obliged to disclose their valuation practices, particularly regarding the use of amortised cost accounting, as well as to provide appropriate information to investors regarding applicable redemption procedures in times of stress.

Reporting and information sharing

- MMFs or their managers, and their sponsor will be obliged to report any instances of sponsor support that may have an impact on the price of the MMF to the competent national supervisory authority, together with a full description of the nature and size of such support.
- MMFs will be subject to enhanced regular (and harmonised) reporting and harmonised data obligations.
- Competent national supervisory authorities will be obliged, where relevant, to share the information on sponsor support and reporting with other national supervisory authorities within the same Member State, or from other Member States, the European Supervisory Authorities, the members of the European System of Central Banks and the ESRB.

Background

The ESRB is part of the European System of Financial Supervision (ESFS), whose purpose is to ensure supervision of the Union's financial system. The ESRB's task is to identify and monitor systemic risk, and to issue policy recommendations to mitigate such risks. The recommendation follows work by the Financial Stability Board (FSB) (27 October 2011), the International Organization of Securities Commissions (IOSCO) (9 October 2012), the US Securities Exchange Commission (SEC) and the Financial Stability Oversight Committee (13 November 2012). The recommendation sets out the rationale for this action on MMFs which include the ESRB's belief that:

- MMFs, while subject to securities markets regulation, are seen as a key component of the shadow banking system, particularly as they perform maturity and liquidity transformation, and may therefore pose systemic risk.
- Investors may perceive MMFs, in particular constant net asset value funds², as safe alternatives to bank deposits. However, MMFs do not have direct access to central bank financing and deposit insurance. There is therefore a risk of confusion with bank deposits which benefit from such a safety mechanics.
- Economic research provides evidence that the conduct and nature of MMFs make them vulnerable to destabilising investor runs, which can spread quickly among funds, impairing liquidity and the availability of short-term credit, in particular for banks. The risk of an investor run may be higher for constant net asset value funds in cases where there is a perception that they would fail to live up to investor expectations of redemption at par.

- Potential systemic risks stemming from MMFs therefore relate to the first-mover advantage of investors, specifically relevant for constant net asset value funds, the implicit and discretionary nature of support by sponsor companies, and the high interconnectedness of MMFs with the rest of the financial system, in particular banks and money markets.
- A general use by MMFs of fair value accounting and, in limited circumstances only, the use of amortised cost accounting³, will provide price transparency to investors, improve investors' understanding of the risks inherent to these MMFs, and make the difference between MMFs and bank deposits clearer.
- Liquid assets help MMFs pay redeeming shareholders and prevent fire sale of assets at a loss, also preventing contagion effects for other funds that hold similar securities. Accordingly, explicit minimum amounts of daily and weekly liquid assets will ensure that MMFs are able to meet potentially large redemption requests from investors and weather periods of market volatility. Effective tools to deal with liquidity constraints, such as temporary suspensions of redemptions, will assist MMFs in dealing with periods of stress.

Timeline for the follow-up

The EU Commission must report to the ESRB and the Council on the actions taken (legislative proposals are expected) in response to the recommendation, or adequately justify inaction in compliance within the following timelines.

- by 30 June 2013, the Commission must deliver an interim report containing a first assessment of the implementation of these recommendations;
- by 30 June 2014, the Commission must deliver a final report on the implementation of these recommendations.

The General Board of the ESRB may extend the deadlines where legislative initiatives are necessary to comply with the recommendation.

Market Reaction

Market reaction has been, at best, lukewarm. Nevertheless there appears to be a groundswell of moves to further regulate the MMF industry. It is worth noting that the US is back to consultation stage on further regulating the US MMF industry. Because the EU Commission must report on the actions taken in response to the ESRB recommendation, or adequately justify inaction, we are likely to see EU legislative proposals fairly soon. Nevertheless there may well be a significant amount of road to run before proposals become final.

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FOOTNOTES:

1. Money market funds means regulated and supervised Union collective investment undertakings whose primary objective is to maintain the principal of the fund, while providing a return in line with money market rates, by investing in money market instruments or deposits with credit institutions.
2. A constant net asset value fund is a money market fund that seeks to maintain an unchanging value per unit or share. Its assets are generally valued on an amortised cost basis.
3. Amortised cost accounting means an accounting approach which considers the acquisition cost of the security and adjusts this value for amortisation of premiums or discounts until maturity.