European Money Market Funds: A Comparative Analysis of US and European *De Facto* and *De Jure* Micro-Processes

Joseph Tanega

University of Westminster Law School

Dr Viktoria Baklanova, CFA

Senior Director/Fitch Ratings

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Key takeaways

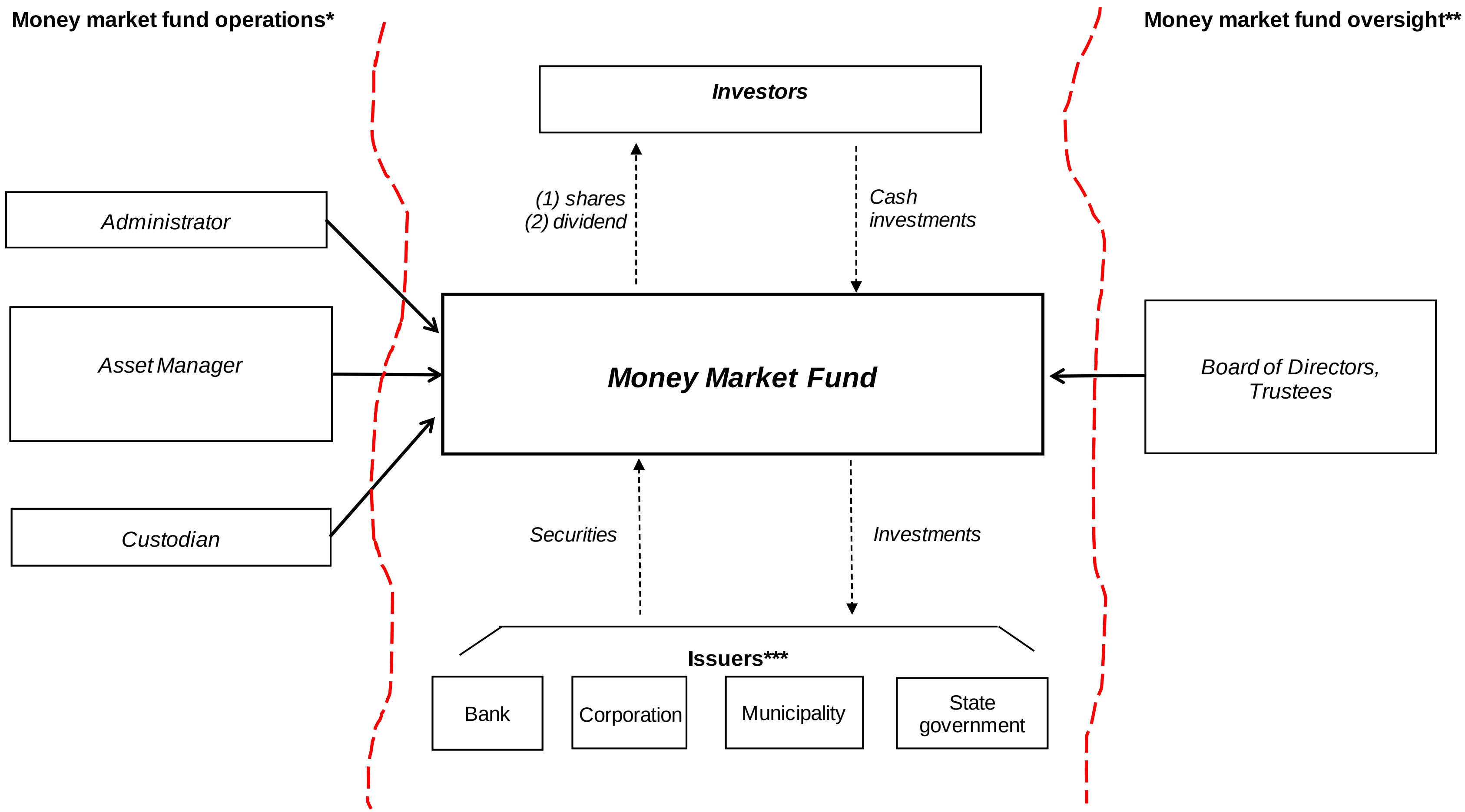
- Diversity of European MMFs rooted in diversity of European local capital markets
- Two divergent trends:
  - Harmonisation
  - Desire for product differentiation
- Two types of transformation:
  - from the market practices that exist *de facto* to their capture and replication *de jure*
  - from the *de jure* ideals of fair rules that encourage further and deeper *de facto* market developments
- Creation of new products under fair rules of transparency that drive new and more resilient markets

Money market funds from *de facto* practice to *de jure* regulations

Research subject and research question

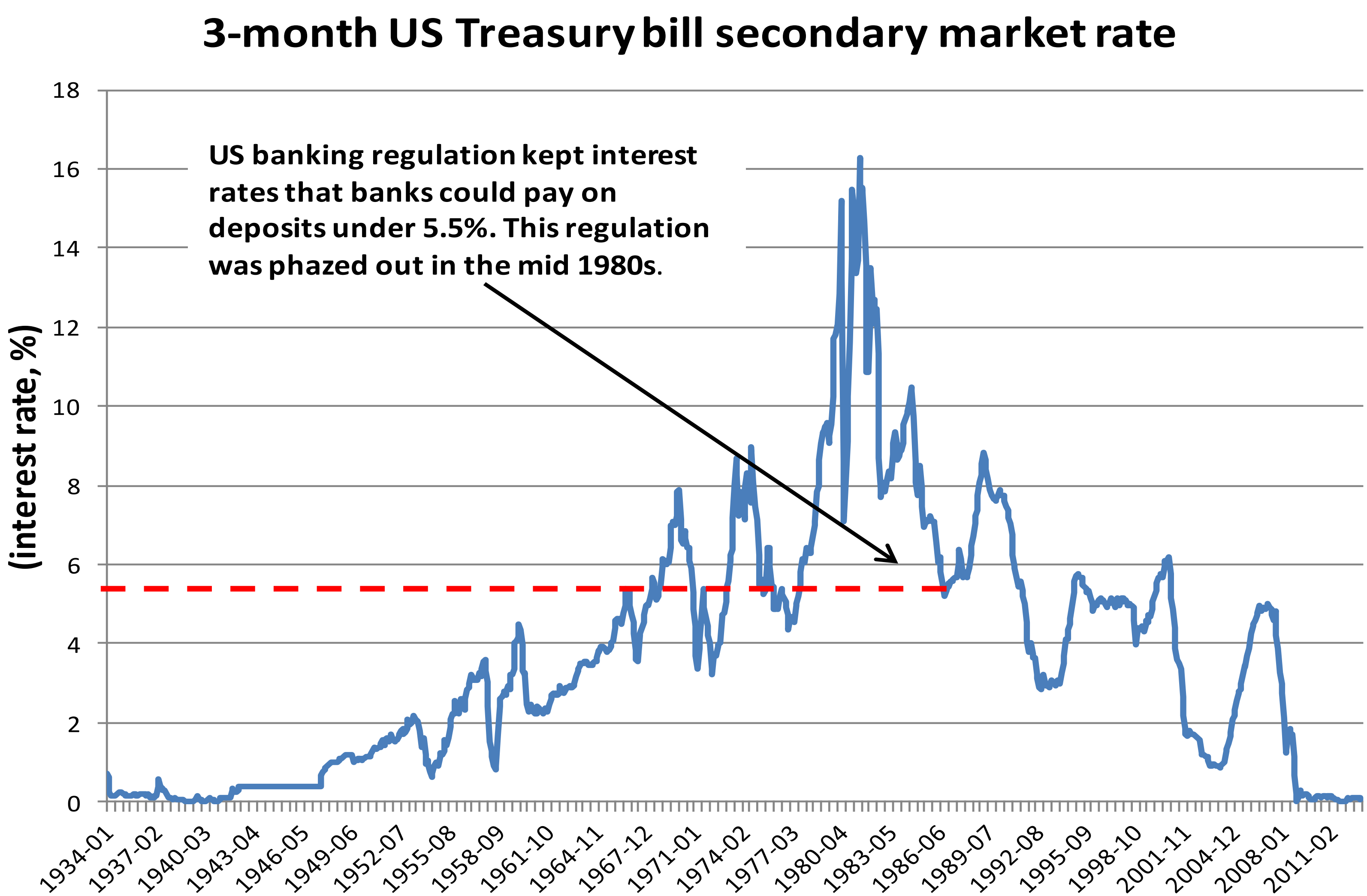
- What are Money Market Funds (MMFs)?
  - Collective investment pools that intermediate credit between cash-surplus entities and cash-short entities (sovereigns, municipalities, banks, corporations)
  - An investment option with the least uncertain outcome
- Why are MMFs important?
  - Issuers: an additional source of short-term funding
  - Institutional investors: mechanism for managing daily liquidity outside the banking system
  - Retail investors: low risk investment option
- How should European MMFs be regulated?

MMF structure



Note:
* Operational support could structured differently depending on jurisdictional requirements
** Oversight could be provided in a different form depending on jurisdictional requirements
*** Issuers of securities purchased by money market funds are not necessarily entities located in the US or the EU, but could be organised/registered in different countries

Regulatory arbitrage theory of MMF origin

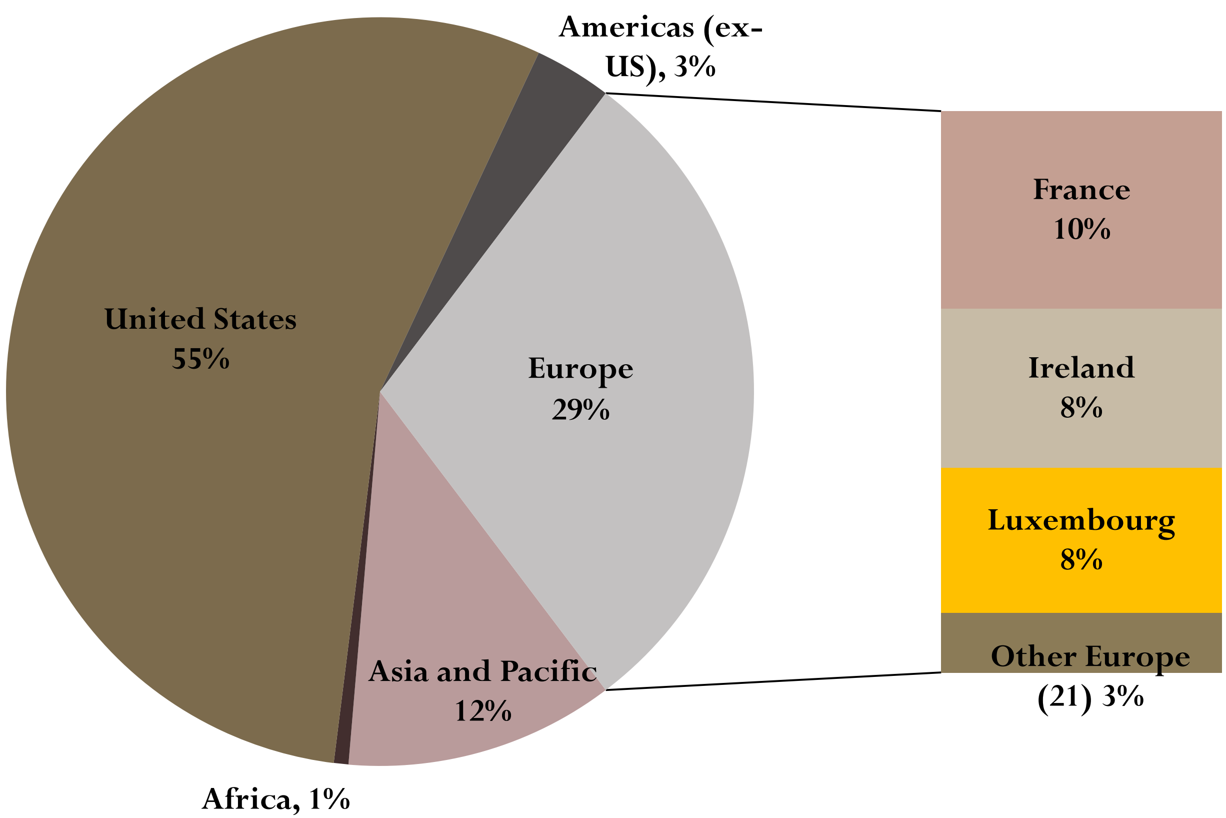


Source: Federal Reserve

European money market funds

Sizing the industry

- Total Word MMFs: €3.6 tn (6.8% of the world's GDP €52.6 tn)
- US MMFs: €1.9 tn (16.8% of the US GDP €13.2 tn)
- European MMFs: €1.1 tn (8.3% of the EU GDP €11.3 tn)



Source: ICI

European MMF landscape

- European MMFs, originated in many different countries, exhibit varying risk profiles
- This diversity is a result of the local nature of investment product offerings
- Many European MMFs are not comparable with those offered in the US
- No targeted pan-European regulation until ESMA's common definition came in effect in July 2011
- European regulators struggled to reach consensus and reverted to having two types of European MMFs:
  - Short-term money market funds (perceived as "US-style")
  - Money market funds

Current MMF regulation

- US:
  - General framework under the federal securities law
  - Targeted regulation: Rule 2a-7 sufficiently re-drafted post-crisis
  - Tax code, bankruptcy code, GAAP
- EU:
  - National regulation (France, Ireland)
  - May or may not be registered as UCITS
  - ESMA's common definition of European MMFs (July 2011)
- Non-governmental regulation:
  - Credit rating agency criteria (in the US and the EU)
  - IMMFA's Code of Practice (in the EU)

Important structural feature: constant net asset value

- US MMFs feature the constant net asset value ($1.00)
  - Invest in the high quality short-term securities
  - Amortised cost accounting (daily) and mark-to-market "shadow" pricing process (weekly)
  - Daily accumulation of income
  - Rounding to the next cent (penny-rounding)
- European MMFs may feature constant (£1.00, €1.00) or variable net asset value
  - ESMA guidance does not require marking to market securities that mature within 90 days
- Because of US MMF share price is fixed at a unit, some regulators believe that investors perceive shares of MMFs as bank deposits

Constant net asset value vs. accumulating/variable net asset value: economic experience is the same

Dividends are accumulated daily and paid out monthly. At the end of each month an investor has $1.00 + dividends

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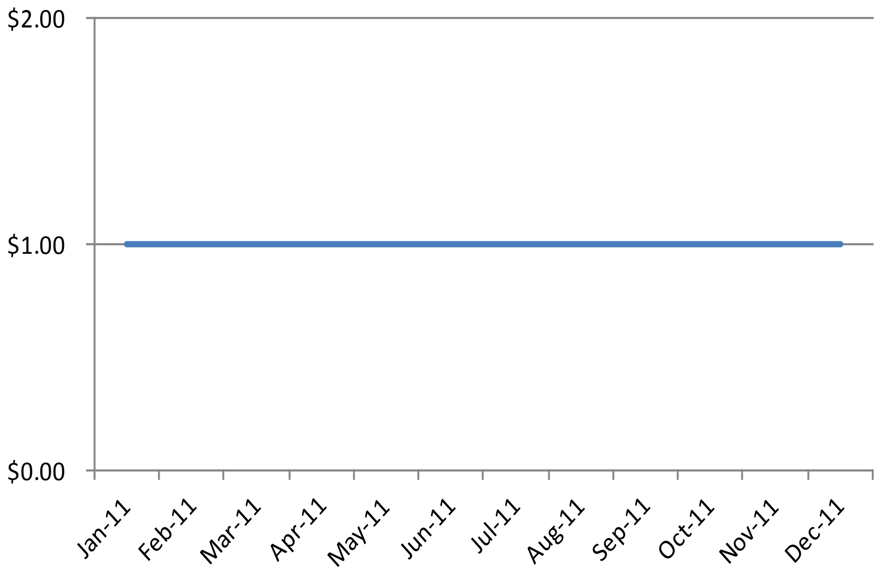
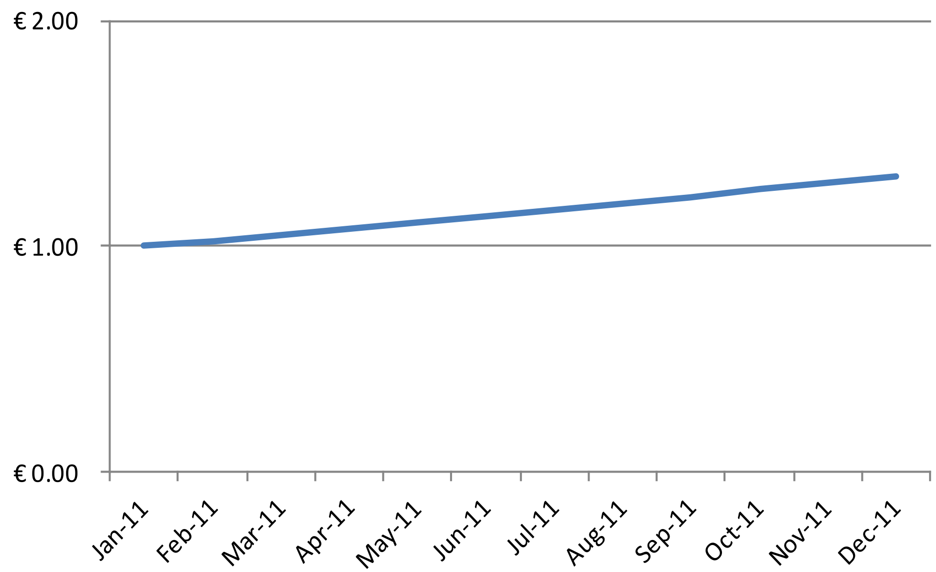




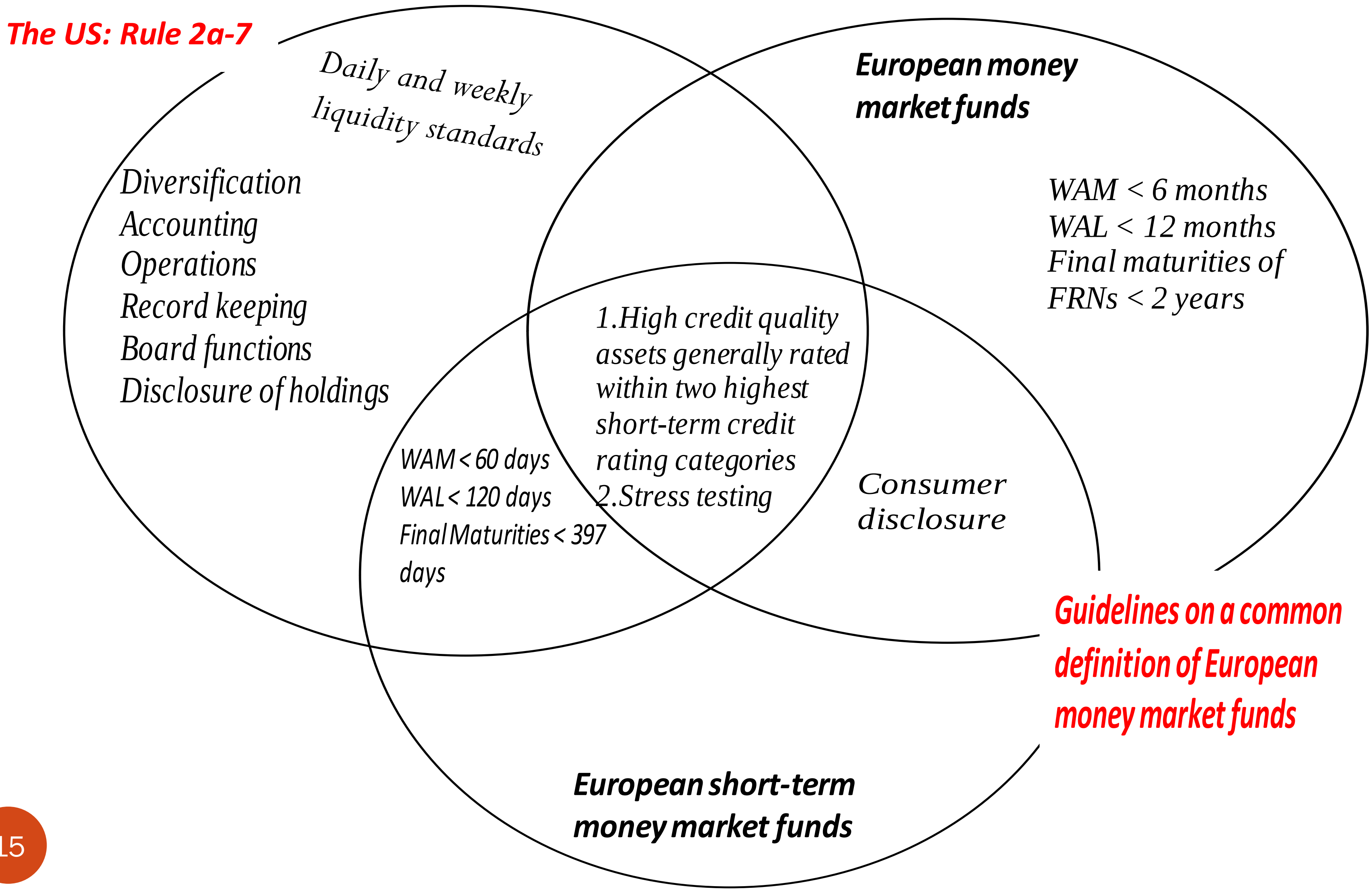
Current proposals for MMF reform

- Nov. 2010: US MMF structural reform as recommended in the Presidents' Working Group Report
- Aug. 2012: SEC inability to issue the MMF structural reform proposal
- Nov. 2012: FSOC issued the structural reform proposal
  - floating net asset value
  - 1% capital buffer and a "minimum balance at risk" hold-back
  - 3% capital buffer and other provisions
- Dec. 2011: ESRB recommendations on USD-denominated funding of Union credit institutions:
  - closely monitor USD funding and liquidity risks by credit institutions
  - encourage diversity of funding sources
- Oct. 2012: IOSCO issued policy recommendations for MMFs

How should MMFs be regulated?

- What should be done about the US MMFs?
- What should be done about European MMFs?
- Does harmonised global MMF regulation make sense?

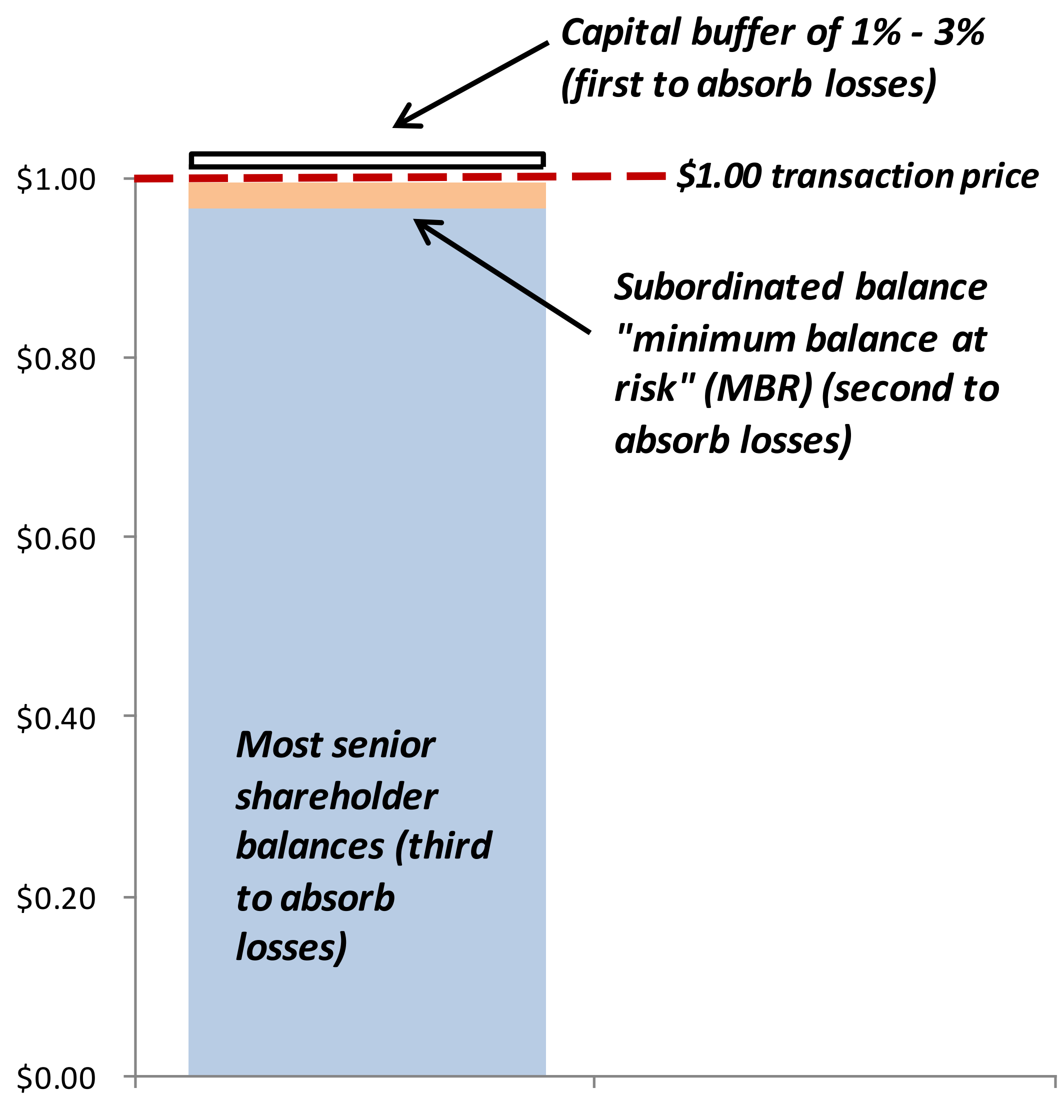
Lack of isomorphism between the US and the EU regulatory models



US MMF structural reform:
no optimal policy solution found

- Investor surveys and comment letters indicate investors' comfort with the current MMF structure
- Each proposal has significant shortcomings
- Removal of constant net asset value feature:
  - decreases MMF utility as a cash management vehicle
  - likely to cause cash flow into less regulated and less transparent vehicles
  - likely to increase larges banks' deposits; counterproductive to a policy objective of ending "too big to fail"
- Capital buffers add leverage; promote "moral hazard"
- "Minimum Balance at Risk" inconsistent with daily liquidity

Capital buffer and “minimum balance at risk”



Source: McCabe (2012)

Observations for framing regulation of European MMFs

- European MMFs are not known for systemic stability concerns
  - Relatively smaller
  - Not a significant source of short-term funding
  - Structurally more diverse relative to US MMFs
- Harmonised global regulation of MMF investment standards may lead to greater systemic risk accumulation
- Elimination of MMFs potentially lead to a greater strain on the real economy; drives cash towards the largest banks; promotes "too big to fail" and potential for bank bailouts

Towards better regulation of European MMFs

- MMFs should be allowed to continue to take risk consistent with their objectives of minimum volatility and liquidity
- Full disclosure of portfolio holdings and market prices → monitoring of funding risks
  - Frequent
  - Publicly available
  - Free
- Disclosure of fund investors → monitoring of possible run
- Global public database → public scrutiny and informed decisions

Contact & disclosure

E-mail: viktoria.baklanova@gmail.com

Viktoria Baklanova is currently employed as an analyst by Fitch Ratings. The views and opinions expressed in this presentation are those of Ms. Baklanova and are not intended to and do not represent, the opinions, views, or policies of Fitch Ratings or the Fitch Group.