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European Systemic Risk Board Paper Series - European Money Market Funds and Financial Stability

[26279]

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TO: ICI GLOBAL MEMBERS
INTERNATIONAL MEMBERS No. 25-12
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 43-12 RE: EUROPEAN SYSTEMIC RISK BOARD PAPER SERIES - EUROPEAN MONEY MARKET FUNDS AND FINANCIAL STABILITY

The European Systemic Risk Board ("ESRB") has issued a paper as part its Occasional Paper Series, Money Market Funds in Europe and Financial Stability ("Paper"). [1] The four authors are staff members of regulatory authorities in France, Sweden and the United Kingdom and the ESRB secretariat. The ESRB states that views expressed in the Occasional Paper Series are those of the authors and do not necessarily reflect the official stance of the ESRB or its member organizations and should not be interpreted as warnings or recommendations by the ESRB.

The purpose of the Paper is to provide a first assessment of the systemic importance of money market funds within the European context, as well as the main areas of risk, policy implications and the possible role for the ESRB.

Systemic Importance of Money Market Funds

The Paper finds that although European money market funds are small in comparison to European credit institutions, money market funds are a significant part of the European asset management industry. Further, the role of money market funds in money markets and short-term funding, as well as their interconnectedness with other parts of the financial system, particularly banks, adds to their systemic importance. In addition, the high share of institutional investors in European money market funds is noted as a characteristic that is likely to generate significant redemption pressure during times of stress and poses concentration risk.

The major countries of domicile for European money market funds are France, Luxembourg and Ireland, representing more than 90% of the European money market fund market as of the end of 2011. Both variable net asset ("VNAV") money market funds and constant net asset value ("CNAV") money market funds are offered in Europe. [2] Money market funds account for approximately 14% of total assets under management of all euro area investment funds and 19% of all UCITs as of the end of 2011. The share of Institutional Money Market Fund Association ("IMMFA") style CNAV money market funds has been growing (approximate market share of 41% at the end of 2010). [3] Currently there are no European level figures distinguishing between European money market funds and European short-term money market funds (STMMFs); however in France, one-half of funds are money market funds (35% of total assets under management) while 43% are STMMFs (60% of total assets under management). STMMFs can have a CNAV or VNAV but the European funds classified as a "money market fund" may only have a VNAV. [4]

Since the adoption of the ESMA money market fund guidelines and the end of the transition period in 2011, the new classifications have significantly impacted the money market fund population with many funds being reclassified as bond funds or mixed funds or funds have closed. For the whole euro area, the total net asset value of money market funds is estimated to have decreased by 18% (EUR 194 billion) since July 2011. [5]

The Paper also examines the role of money market funds, including US money market funds in short-term financing and bank funding in Europe. The Paper also generally describes potential implications of new prudential rules, e.g., impact of Basel III, structural challenges for money market funds, e.g., low short-term interest rates, and industry consolidation. [6]

Risks Associated with Money Market Funds

The Paper views money market funds as exhibiting the characteristics of shadow banking – maturity transformation, deposit-like features, cash equivalent treatment and susceptibility to runs. The Paper takes the position that the risks associated with money market funds arise from potentially risky assets that may mature in a year (or more) and the issuance of redeemable shares in funds viewed as safe. The Paper states that European money market funds have little ability to absorb losses and no official liquidity backstop and as a result they are vulnerable to runs. The Paper highlights a number of areas where concerns remain, including CNAV and, more generally, the use of amortized cost accounting, the reliance on ratings, the issue of implicit support and the potential risk of contagion to sponsors. [7]

Accounting valuation is described. The Paper takes the position that the "first-mover advantage" predominantly concerns CNAV funds but concedes the experiences in VNAV funds during the financial turmoil also show that investors may have an incentive to divest if they suspect there are valuation or liquidity uncertainties in VNAV money market funds. The Paper also recognizes that the values of some VNAV money market funds may not vary much relative to a CNAV money market fund. [8]

The Paper also describes concerns raised by ratings, including the reliance of managers on ratings and the ratings of money market funds themselves. In the case of triple-A rated money market funds, the Paper expresses concern that investors may be given a false sense of security and that a rating of such a fund provides some form of credit transformation since the fund could hold securities rated lower than triple-A. [9]

On differences between the US and the EU, the Paper raises general risk concerns due to potential regulatory arbitrage. [10]

Money market funds as channels of contagion as an area of risk are also described in the Paper. For example, concerns are expressed regarding the role of money market funds in short-term funding markets and the impact of their actions when they withdraw or change their investing activities. Their size and influence also may influence the nature of markets. Links with sponsors and the roles of sponsors are also examined as the links may increase the potential for contagion to sponsors. Money market funds also are portrayed as a volatile source of funding with the example of US money market funds decreasing their exposure to European banks during 2011. Repos are also portrayed as how money market funds manage excess balances however the Paper expresses concern that money market funds may hold collateral which they cannot "naturally" hold if there is a counterparty default which could lead to fire sales. [11]

Policy Implications

The Paper lists the main reform options and refers to the work of the International Organization of Securities Commissions ("IOSCO") and US discussions. The paper recognizes that although money market funds have long been subject to securities market regulations, the existing frameworks may need to be complemented and revised in order to address broader concerns related to financial stability.

The Paper recommends that both direct and indirect regulation be considered, including a move to a floating net asset value, the introduction of capital/NAV buffers and the development of new standards for portfolio liquidity or valuation or procedures during times of stress. The Paper also suggests designing a resolution framework for winding down funds, examining the issues around ratings, designing a framework to address sponsor relationships and exploring better convergence between the United States and Europe. [12]

The Paper recognizes that there are substantial factors that complicate the analysis of reforms, including the moral hazard posed by certain approaches, the potential adverse consequences of money shifting out of money market funds to less regulated funds or impacts on the availability, length and cost of financing. The Paper also identifies risks arising from the possibility of regulation leading to increased consolidation of the industry. [13]

On monitoring, the Paper identifies various initiatives to improve monitoring and the ability to assess risks to financial stability. On portfolio disclosure, the Paper recognizes that the increased portfolio disclosure of US money market funds has allowed better monitoring but also believes it may exacerbate redemption pressures and fire sale effects. In addition the Paper believes it is unlikely that all investors will have the resources and capabilities to monitor and analyze the information. [14]

Next Steps

The Paper states that various policy options must be thoroughly assessed and carefully considered in the context of their potential impact on financial stability and market functioning. For the ESRB, the Paper states that it could conduct further analysis on the role of money market funds in providing finance to the economy, the differences in money market fund profiles and develop possible policy recommendations to strengthen their robustness and address the related macroprudential implications. ESRB work also could serve as an input for the European Commission's consultation on shadow banking. [15]

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endnotes

[1] Money Market Funds in Europe and Financial Stability, ESRB Occasional Paper Series, No. 1, June 2012, Julie Ansidel (Autorité des Marchés Financiers)(France), Elias Bengtsson(Sveriges Riksbank)(Sweden), Daniele Frison (ESRB Secretariat) and Giles Ward (Financial Services Authority) (United Kingdom) available at http://www.esrb.europa.eu/pub/pdf/occasional/20120622_occasional_paper.pdf?128ace064d8cdde9184fcafd3c3df56c

[2] See Report at Appendix 3 (describing difference between CNAV and VNAV as principally due to an accounting technique under which CNAV funds value all their assets using amortized cost accounting and VNAV funds use mark-to-market to value some of their assets).

[3] See also Report at Appendix 7 (investor base of IMMFA funds).

[4] Paper at 8-10

[5] Paper at 10.

[6] Paper at 10-12.

[7] Paper at 13-22.

[8] Paper at 14-15.

[9] Paper at 16.

[10] Paper at 16-17. See also Report at Appendix 5 (comparison chart of EU and US regulation of money market funds).

[11] Paper at 18-22.

[12] Paper at 23-25.

[13] Paper at 25-26.

[14] Paper at 27-28.

[15] Paper at 3.
