EU Money Market Reform: The Wait Is Finally Over

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Table Of Contents
Where Did Reform Come From?
Key Aspects Of The Reform
Reform Bodes Well For The Future Of The Industry
Related Criteria And Research
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After years of contested debates about the pros and cons of regulation for European money market funds (MMFs) and 10 years after the start of the global financial crisis, the EU finally has its own MMF legislation, approved by the European Council on May 16, 2017. This third and final step in a very lengthy regulatory process, will see the "Regulation of the European Parliament and of the Council on Money Market Funds" come into force.

S&P Global Ratings rates European domiciled MMFs mostly denominated in U.S. dollars, British pound sterling, and euros, collectively totaling approximately €630 billion in assets under management as of March 2017. In this article, we provide our views on the newly published EU MMF reform and what it means for those MMFs that we rate. We also offer our view on the future of the industry, particularly how the reform provides sound policies and practices for MMFs to follow, and the effects of the explicit nature of the reforms on the industry.

Overview

• After much delay and debate, EU MMF reform is finally here and the industry can move forward.
• In our view, the increased transparency, enhanced liquidity, and investor protection outlined in the new regulations are positive developments for the industry.
• Notably, we anticipate that the introduction of new rules in Europe will not affect European domiciled MMFs assessed under our PSFR criteria.
• The explicit nature of the reforms will likely create a pool of homogenous MMFs, which could then result in further fund mergers reducing competition in the marketplace.

With regulatory uncertainty now out of the way, the €1.2 trillion EU MMF industry, from its more humble beginnings in France in the 1980s, can finally move forward. In recent years, and since the first EU MMF reform proposal in 2013, the industry has been treading water due to political inaction and significant lobbying and campaigning efforts from opposing sides. For more than 40 years prior to these regulatory changes, numerous countries such as France, Spain, Italy, Germany, Luxembourg, Ireland, and the U.K. each maintained their own guidelines for MMFs.

Where Did Reform Come From?

For most of its existence, the European MMF industry went unnoticed to the average investor. However, 10 years ago, some MMFs strayed from their founding principle of capital preservation and liquidity, with an emphasis on yield thrusting the industry into the spotlight of regulators and investors alike. This was largely caused by the revelations that some MMFs offered by European asset managers were unable to facilitate liquidity for shareholders due to the investment in illiquid asset-backed securities subsequently suspending shareholder redemptions.

For those in the industry at the time, it was unheard of that a MMF would not be able to fulfil its redemption requests. Events like this created a wave of anxiety across the global MMF industry, culminating with a U.S. MMF called
Reserve Primary Fund “breaking the buck” in September 2008 following Lehman Brothers’ default. Since that time, global regulators have been working to understand the intricacies and systemic nature of the industry, aiming to improve its resilience to market crises, to minimize its systemic risk, and to refocus a MMF’s original purpose, as an overtly safe investment.

In 2009, the Committee of European Securities Regulators (now known as the European Securities and Markets Authority or ESMA) proposed guidelines and two common definitions of MMFs. Some viewed these proposals as positive developments for the EU MMF industry because they clarified how the market should operate, considering the philosophical differences between a U.S.-styled MMF offering a constant net asset value (CNAV) and the continental (French) style MMF offering a variable net asset value (VNAV). However, the guidelines failed to create a minimum level playing field for MMFs in the EU, since more than half of the EU countries did not apply the guidelines and common definitions in their national law. In addition, the strict definitions caused numerous fund providers to exit the business between 2010 and 2012.

Up until this point in time, MMFs in Europe took very diverse approaches to investment strategy, depending on the country of registration. That said, from 2009 to 2012 and under the ESMA guidelines, the industry ticked along almost unnoticed (like its first 30 years) undertaking conservative investment practices, providing liquidity to investors and supplying short-term financing to a wide variety of borrowers. This has all taken place amidst zero or negative interest rates in euros, and a reduced demand for cash from banks, which have benefited from the European Central Bank providing ample liquidity. The political debate about how to reform MMFs persisted during this period and in September 2013, the European Commission (EC) released its first regulatory proposals to reform money market funds (MMFs) domiciled or sold in Europe. (see “EC Regulation For Money Market Funds May Have Unintended Consequences,” published on Nov. 29, 2013).

**Key Aspects Of The Reform**

The new regulation provides investors with a degree of optionality for investing their short-dated cash, by offering two types of MMFs:

- Short-term MMFs with the objective of offering money market rate returns, while ensuring the highest possible level of safety for the investors; and
- Standard MMFs with the objective of offering returns slightly higher than money market returns, and they therefore invest in assets that have an extended maturity.

In addition, the regulation introduces three new structural options, within the short-term MMF category:

- Public debt CNAV: A MMF that seeks to maintain an unchanging net asset value (NAV) per unit or share and invests 99.5% of its assets in government debt instruments, reverse repos collateralized with government debt, and cash.
- Low volatility net asset value (LVNAV): A MMF permitted to maintain a constant dealing NAV, provided that certain criteria are met, including that the fund's market NAV does not deviate from the dealing NAV by more than 20 basis points.
- Variable NAV: A MMF that prices its assets using market pricing and therefore offers a fluctuating NAV.
Table 1 demonstrates some of the key requirements each type of MMF will need to follow.

### Table 1

<table>
<thead>
<tr>
<th></th>
<th>Short-term MMFs</th>
<th></th>
<th>Standard MMFs</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible investments</td>
<td>Government debt, reverse repo, cash</td>
<td>Money market instruments (MMI)</td>
<td>MMI</td>
<td>MMI</td>
</tr>
<tr>
<td>Asset credit quality</td>
<td>To be deemed to be high-quality as per internal assessment of MMF's manager</td>
<td>To be deemed to be high-quality as per internal assessment of MMF's manager</td>
<td>To be deemed to be high-quality in accordance with internal assessment of MMF's manager</td>
<td>To be deemed to be high-quality in accordance with internal assessment of MMF's manager</td>
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<tr>
<td>Diversification limits</td>
<td>Up to 100% in government debt, 15% per reverse repo counterparty</td>
<td>5% per issuer but with some exceptions (i.e. bank deposits [10%], reverse repo [15%])</td>
<td>Ranging from 10 -20% per counterparty or MMI</td>
<td>Ranging from 10 -20% per counterparty or MMI</td>
</tr>
<tr>
<td>Valuation approach</td>
<td>Amortized cost accounting</td>
<td>Amortized cost accounting &lt;75 days</td>
<td>Mark-to-market valuation</td>
<td>Mark-to-market valuation</td>
</tr>
<tr>
<td>Maximum weighted-average maturity (WAM)</td>
<td>60 days</td>
<td>60 days</td>
<td>60 days</td>
<td>6 months</td>
</tr>
<tr>
<td>WAL (max)</td>
<td>120 days</td>
<td>120 days</td>
<td>120 days</td>
<td>12 months</td>
</tr>
<tr>
<td>Maturity (max)</td>
<td>397 days</td>
<td>397 days</td>
<td>397 days</td>
<td>2 years, with 397 day reset</td>
</tr>
<tr>
<td>Daily liquid assets (min.)</td>
<td>10%</td>
<td>10%</td>
<td>7.50%</td>
<td>7.50%</td>
</tr>
<tr>
<td>Weekly liquid assets (min.)</td>
<td>30% with up to 17.5% of high quality public debt instruments</td>
<td>30% with up to 17.5% of high quality public debt instruments</td>
<td>15% with up to 7.5% in weekly redeemable MMI and MMF units/shares</td>
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</tr>
<tr>
<td>Potentially enforceable fund board actions</td>
<td>Liquidity fees and gates</td>
<td>Liquidity fees and gates</td>
<td>Liquidity fees and gates</td>
<td>Not subject to liquidity fees or gates</td>
</tr>
</tbody>
</table>

Note: The metrics displayed are not an exhaustive list of new regulations, but a summary of the main aspects covered in the regulation.

### Diversification

From a transparency and risk mitigation standpoint, the industry welcomes the introduction of defined diversification limits specific to each MMF fund type, as currently, such measures are adopted only on a best practice basis, with a 5% per issuer diversification limit generally considered the industry standard.

Since 2011, we have applied a 5% per issuer limit for our rated MMFs in Europe with certain higher limits for investments in high credit quality government investments, overnight bank deposits, and collateralized investments (such as reverse repurchase transactions).

In early 2016, when we revised the 2011 version of our principal stability fund rating (PSFR) criteria, we introduced a concept called high bank concentration (HBC). The HBC metrics reflect an increased tolerance to portfolio concentration to banks with the highest short-term rating (‘A-1+’). We introduced this concept knowing that in certain global MMF jurisdictions, banking markets can be dominated by a small number of high creditworthy institutions (for example, in Australia, Canada, and Norway). Banks rated ‘A-1+’ typically have strong capital and liquidity and often have systemic importance in their country.

Interestingly, within the new MMF regulation, there is also a provision for flexibility in diversification requirements related to highly concentrated banking sectors. We believe this is a positive step for MMFs across the EU, as
diversifying for the sake of diversifying into lower credit quality entities can exacerbate market and liquidity risks for a MMF. By investing more heavily in an entity with higher creditworthiness, the reduced default probability should diminish the volatility of a MMF’s NAV due to losses incurred from credit risk.

**Asset credit quality**

The new asset quality provisions applicable to all types of MMFs require MMF managers to invest in issuers or instruments that they deem to be high quality according to their own internal credit assessment. In addition, MMF managers will be required to comply with a prescribed credit assessment procedure. The EU Commission will formulate additional clarifications on the applicable criteria to derive this assessment and adopt delegated acts. MMFs that we rate 'AAAm' generally invest in assets rated 'A-1' or better. We expect MMFs that we rate to comply with the regulation for new asset credit quality requirements, while continuing to comply with the minimum credit quality of assets as assessed by credit rating agencies in order to preserve transparency and maintain their fund rating.

We expect the new asset quality provisions for MMFs to enhance MMF providers' independent internal credit analysis and limit over-reliance on external credit ratings. In our opinion, the MMF manager will have more flexibility and latitude in its issuer or instrument selection and retention, which will no longer be constrained by a minimum credit rating. Considering this flexibility and the transparency rating agencies have in terms of criteria and their produced rating rationales, we do believe that a level of consistency or harmonization should be applied to MMFs to conduct their internal credit quality assessment in order for investors to understand how that credit assessment was determined.

**Valuation approach**

We do not support one valuation model in particular (i.e., the use of amortized cost or mark-to-market), since we rate MMFs using either valuation type. We view transparency and consistency in pricing policies to investors on the valuation of investments as an important aspect of prudent fund management.

**Maturity**

Credit rating agencies like S&P Global Ratings have been important participants in the MMF industry in Europe for 25 years. When we assigned our first ‘AAAm’ PSFR rating in 1983, the weighted-average maturity (WAM) limit, a metric to help monitor a MMF's interest rate sensitivity was 60 days. By contrast, the SEC had set a MMF's WAM limit to 90 days under Rule 2a-7. At that time, a 90-day WAM corresponded to a PSFR of 'BBBm'. In 2011, following our periodic review of our criteria and our observations during the financial crisis that numerous global MMFs' credit duration was not restricted, we introduced a "WAM to final" metric (also called the weighted-average life or WAL), ranging from 90 to 120 days. This was intended to limit MMFs from having significant floating-rate note (FRN) exposure, considering their increased likelihood of price instability relative to government investments, long considered a flight to quality asset. The new EU MMF reform has matched the WAM limits already applying to our 'AAAm' rated funds, but continues to show a subtle difference in terms of a MMF's WAL (or WAM to final metric). How this provision unfolds, is yet to be seen, considering negative interest rates and the tendency for MMFs to look further along the duration curve for an incremental pick-up in yield to distinguish themselves from competitors.

**Liquidity**

Interest rate sensitivity is not the only factor that can affect the principal value of a MMF's portfolio. A portfolio's
liquidity is critical to maintaining the stability of a fund's NAV. The new EU MMF reform contains newly introduced metrics for MMFs to observe daily and weekly liquidity amounts. The introduction of such metrics is consistent with other global regulators who have also introduced such measures. The interesting point to note is what the daily and weekly amounts can comprise and how there are different limits to different types of MMFs. Both public debt CNAV and LVNAV MMFs need to maintain at least 10% of their investments in overnight investments and 30% in a weekly allocation. Short-term VNAVs are required to maintain these amounts at 7.5% and 15%, respectively.

For transparency, S&P Global Ratings does not apply a minimum amount of liquidity for rated MMFs because each rated fund's liquidity needs are dynamic. Therefore, maintaining a 30% weekly liquidity bucket could be overly conservative for one fund, but insufficient for another. We also believe that in an extreme circumstance, a MMF should be able to liquidate its entire portfolio of high credit quality short-duration investments to meet redemptions.

In our experience, the best defense a MMF can offer against unexpected shareholder redemptions or battling against "hot-money" (investor money that is frequently transferred to maximize capital gain) is by investing in high credit quality, short-duration, and liquid investments.

Other aspects of reform: External support, stress testing, and know your client

The final European MMF regulations include a ban on external support. External support is defined as cash injections, asset purchase at an inflated price or with the purpose to provide liquidity, the issuance of an implicit or explicit guarantee, or any action to maintain the liquidity profile of the NAV. Since our PSFRs are based on a fund's independent ability to maintain principal stability and limit exposure to losses resulting from credit risk and do not include a fund sponsor's willingness or ability to support the fund's NAV, this rule is consistent with our approach to MMF ratings.

Stress testing is an important element of a MMF's risk management practices. S&P Global Ratings has performed stress testing on its rated MMFs for more than 20 years, when we introduced our "sensitivity matrix". This is a tool available to fund sponsors to assess market metrics including, interest rate and credit spread movements, as well as fund redemptions and their impact on a fund's NAV, either in isolation or a combined basis. We do advocate that in stressful market conditions, most MMFs would gain some knowledge from this type of stress testing, but given the requirement for a MMF to conduct stress testing only on a minimum biannual basis, market events could arise and affect MMFs that only intermittently conduct stress testing. In our view, highly-rated funds should conduct stress tests at least monthly.

Under the regulation, know your client (KYC) is one of the key aspects a MMF needs to incorporate as part of its risk management practices. In reality, a MMF is an investment vehicle that provides safety and liquidity to its shareholders. To provide that liquidity to its shareholders, a MMF should have a solid understanding of the investor's redemption pattern. Whether it's a weekly, monthly, or a quarterly requirement, the due diligence a MMF undertakes on its expected redemptions—especially in tough market conditions (like year-end)—is imperative for protecting the remaining shareholders.

Cash flow calendars, historical flow analysis, and active sales/client relationship teams are tools that MMFs providers can use to channel information to the portfolio managers in order for them to prepare a portfolio to meet the investor's redemptions.
If redemption patterns are unknown from a particular investor, then a MMF should deploy a more conservative approach by investing to a short-time horizon and/or limit the relative weight of such investor in the fund. While we do not have specific criteria metrics around KYC, this is covered under our comprehensive review of fund management.

**Reform Bodes Well For The Future Of The Industry**

We support the efforts made to introduce regulation that focuses on increasing the safety and liquidity of the EU MMF industry. In our view, the increased transparency, enhanced liquidity, and investor protection outlined in the new regulations are positive developments for the industry. Notably, we anticipate that the introduction of new rules in Europe will not affect European domiciled MMFs assessed under our PSFR criteria.

We believe the steps taken since reform was first announced in 2013 have resulted in an improved and more focused legislative framework that placates both sides of the political and industry debate, namely CNAV advocates (supporting U.S.-style MMFs) and VNAV advocates, generally found in continental Europe (i.e., French-styled MMFs).

We expect fund providers will favor the LVNAV product amongst the rated universe of funds. Unlike what occurred with the U.S. reform in 2016, it’s likely there will be very little investor appetite for the public debt CNAV funds, considering that such funds are not exempt from the application of fees and gates. We don’t estimate many existing VNAV funds switching to LVNAV structures as their underlying investors are already cognizant with the mechanics of investing in VNAV MMFs. As investors digest the changes and asset managers engage with their stakeholders, it’s quite possible that certain asset managers could offer all three types of "short-term MMFs," but such a product offering could be subject to challenges relating to a fund's critical mass.

Some of the positive market reception on the final regulations revolved around the exclusion of most of the contentious issues originally proposed from the final reform, notably the 3% capital buffer, a ban on MMF ratings, the mandatory conversion to VNAV, and the removal of asset-backed commercial paper (ABCP) as an eligible asset. Certain aspects of the final regulations were consistent with the original proposal, such as the WAM/WAL limits, while certain aspects were slightly adjusted (for example, credit research requirements and liquidity requirements from the original 2013 proposal). The daily and weekly portfolio liquidity requirements will now apply to both "short-term" and "standard" MMFs, where there were no such requirements under ESMA guidelines.

In our view, the new EU MMF reform provides sound policies and practices for MMFs to follow into the future, especially considering their systemic importance and important funding role to local economies. The explicit nature of the reforms will create a pool of homogenous MMFs, which could then result in further fund mergers reducing competition in the marketplace—a fairly common activity since 2009. Worryingly though, a reduced marketplace only increases the size of the remaining funds and their heightened systemic importance within the EU capital markets.

**Related Criteria And Research**
EU Money Market Reform: The Wait Is Finally Over

Related Criteria
- Principal Stability Fund Rating Methodology, June 23, 2016

Related Research
- EC Regulation For Money Market Funds May Have Unintended Consequences, Nov. 29, 2013

Only a rating committee may determine a rating action and this report does not constitute a rating action.