Money Market Funds Regulation ("MMFR")

Introduction

Almost four years after the initial proposal for regulation of Money Market Funds ("MMFs") by the European Commission, the European Parliament and the Council published the MMFR in June 2017. MMFR applies from 21st July 2018 for any new MMFs created while existing MMFs will have until the 21st January 2019 to comply.

The investment objective of an MMF is to preserve the fund's principal and achieve returns that are in line with interest rates of money market instruments. MMFs must invest in high quality money market instruments and deposits with credit institutions.

MMFR introduces a number of different types of MMFs and introduces a number of new rules and requirements regarding the operation of MMFs.

Types of MMFs

Under MMFR, MMFs may be established as:

- Short-term constant net asset value MMFs (Public Debt "CNAV MMFs") that invest 99.5% of assets in qualifying government debt. They seek to maintain a stable NAV of €1 per share and use the amortised cost valuation method.
- Short-term low volatility net asset value MMFs ("LVNAV MMFs") that invest in "prime" money market fund assets and maintain a constant NAV (within certain parameters). This is a hybrid MMF that can use the amortised cost accounting method to value assets subject to certain conditions and must use the mark-to-market method where these conditions are not met.
- Short-term variable NAV ("VNAV") MMFs that invest in "prime" money market fund assets and maintain a variable NAV. They use a mark-to-market valuation method.
- Standard Variable NAV MMFs, which are the same as short-term variable NAV MMFs but invest in assets with long maturity. They use a mark-to-market valuation method.

Over 20% of Irish domiciled funds are MMFs. The vast majority of Irish MMFs are currently established as CNAV MMFs. CNAV MMFs are also very common in Luxembourg, whereas other domiciles such as France are exclusively VNAV domiciles. In total, CNAV MMFs represent €90.8 bn of assets in the EU.

Traditionally CNAV funds have used a share cancellation technique, which requires the cancellation of units to allow CNAV MMFs to maintain a stable €1 per share NAV. However, this technique has been deemed to be inconsistent with MMFR and has been banned. The traditional CNAV MMFs have been replaced by the new public debt CNAV MMFs which are subject to stricter conditions in terms of eligible investments to ensure their stability and resistance to market shocks. As mentioned above, they must invest 99.5% of assets in qualifying public debt.

The European Commission had originally proposed to effectively ban CNAV MMFs in the EU. However, following intense negotiations, the CNAV product has been preserved. The new LVNAV structure is a hybrid, which can support a constant NAV of €1 per share as long as the mark-to-market price of the MMF remains within a twenty basis point range, called a collar. If the MMF mark-to-market price falls outside this range, it is required to convert to a VNAV.

New Requirements for MMFs

Portfolio Composition

Eligible portfolio holdings of an MMF under the MMFR regulation include:

- Money market instruments including eligible securitisations and asset backed commercial paper ("ABCPs").
- Deposits with less than twelve month maturity with eligible credit institutions.

- Certain financial derivative instruments (exclusively to hedge interest rate or exchange rate risks).
- Repurchase agreements for liquidity management purposes.
- Units of other MMFs.

MMFs will be prohibited from:
- Short selling money market instruments, securitisations, ABCPs and units of other MMFs.
- Entering into securities lending agreements or securities borrowing agreements.
- Taking direct or indirect exposure to equities or commodities.
- Borrowing or lending cash.

In addition to the above rules on eligible assets and investment restrictions, MMFs will be subject to detailed diversification and concentration requirements. These include rules permitting MMFs to invest only up to 5% of their assets in instruments issued by the same issuer. This limit may be increased to 10% subject to a combined cap of 40% of the MMF assets permitted in investments that each exceed 5% of MMF assets. In addition, MMFs may invest no more than 10% of their assets in deposits with the same bank.

Liquidity Risk Management
The manager of an MMF will be required to introduce a due diligence process to anticipate the effect of simultaneous redemptions by several investors. This process should, at a minimum, consider at least the type of investor, the number of units or shares in the fund owned by a single investor and the evolution of inflows and outflows.

Each MMF will be required to have in place sound stress testing processes, which identify and assess possible future events or changes in economic conditions, which could have adverse effects on the MMF. Regular stress testing for possible scenarios will have to be conducted.

MMFs must have certain liquidity management thresholds in place. These may be summarised as follows:
- CNAV MMF: 10% held in daily maturing assets and 30% in weekly maturing assets.
- LVNAV MMF: 10% held in daily maturing assets and 30% in weekly maturing assets.
- VNAV MMF: 7.5% held in daily maturing assets and 15% in weekly maturing assets.

Internal credit quality assessment
Each MMF manager will need to apply an internal credit quality assessment procedure to determine the credit quality of the MMF’s assets. The internal credit quality assessment procedure and credit quality assessment will need to be well documented.

Portfolio Valuation
CNAV MMFs and LVNAV MMFs (in certain conditions) may be valued using the amortised cost model as outlined above. Other MMF assets will need to be valued on an at least daily basis, using mark-to-market whenever possible. Should this not be possible due to insufficient quality of the market data, an MMF should be valued conservatively using a mark-to-model.

External support
An MMF will not be permitted to receive direct or indirect external support from a third party. This includes cash injections, purchase of the assets of the MMF at an inflated price or purchase of units/shares of the MMF in order to provide liquidity to the fund.

Transparency and reporting
An MMF will have an obligation to report to both its investors and the competent authority.

On a weekly basis, an MMF will be required to report to its investors a number of items including:
- The maturity breakdown of the portfolio.

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- The credit profile.
- The weighted average maturity (“WAM”) of the MMF.
- Details of the ten largest holdings.
- The total value of assets.

The MMF will be required to report to the competent authorities on a quarterly basis. The reported information must include:

- The type and characteristics of the MMF.
- Portfolio indicators such as the total value of assets, NAV and WAM.
- The result of stress tests (including the proposed action plan where applicable).
- Information on the assets held in the portfolio.
- Information on the liabilities of the MMF.

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KB Associates offers a range of services to investment funds and management companies including:

- The provision of UCITS/AIF management company services.
- The provision of designated persons to perform UCITS business plan and AIFMD programme of activity managerial functions.
- The provision of UCITS/AIF operational support.

If you would like to discuss any matters raised in this article or related to KB Associates’ services in general, please feel free to contact Mike Kirby (+353 1 667 1980), Peter Northcott (+44 203 170 8813) or Mike Parton (+1 345 946 4224).

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