Funds oppose shock treatment

__Jakob de Haan__ looks at the differing views on how best to regulate European money market funds after the stress and problems they suffered during the Covid pandemic

Money market funds have two functions: they offer relatively safe short-term investment vehicles to those with cash and they provide short-term lending to banks, businesses and governments. They issue shares to finance their activities and the value of the shares fluctuates in line with the price of the short-term debt instruments in which they invest.

There are three main types of short-term money market funds.

1. Variable net asset value funds offer redemptions or purchases at a price equal to the fund's net value per share. A total of 45% of money market funds in the EU are of this type.
2. Public debt constant net asset value funds aim to offer an unchanging net asset value per unit or share. About 7% of money market funds in the EU do this and they must put 99.5% of investments in government assets.
3. Low volatility net asset value (LVNAV) funds have a share price that remains constant within a 20bps collar. Around 48% of EU money market funds come under this heading.

In the early stages of the Covid-19 pandemic, some European money market funds faced significant liquidity issues because redemptions rose at the same time as the liquidity of the underlying debt instruments fell. But none of the EU money market funds suspended redemptions, applied liquidity fees to redemptions, or put in place redemption gates. But it became clear that several funds were not sufficiently resilient to absorb the shocks and that spilled over into other sectors of the financial system. Timely interventions by central banks helped to contain the stress and calm financial markets.

The episode illustrated three key vulnerabilities in the EU money market fund sector.

- First, investment in private debt assets exposes the funds to liquidity risk.
- Second, LVNAV funds are particularly vulnerable to liquidity shocks as they invest in non-public debt assets while offering a stable net asset value.
- Third, fund managers drew down liquid assets to differing extents, suggesting low levels of buffer usability.

EU money market funds are regulated under 2019 Money Market Funds Regulation but the European Securities and Markets Authority (Esma) has already proposed several changes in the light of the March 2020 experiences.

The sector strongly opposes most of these reforms, arguing that they successfully withstood the March 2020 shock, but I doubt whether they could have done so without the support of central banks.

There seems to be broad agreement on one amendment of the regulation, which would remove the tie between breaching liquidity requirements and the activation of liquidity fees and redemption gates and suspensions. The original regulation could potentially trigger runs because, if liquidity fell towards the regulatory threshold, investors would have an incentive to leave first to avoid redemption fees and gates. By letting the fund decide whether these instruments should be used, the risk of runs falls.

Probably the biggest disagreement is around LVNAV fund valuations. Esma's first proposal is that, for the valuation of private debt assets, money market funds should not use the amortised cost method, irrespective of the investor base or the assets they hold. That would have an impact on LVNAV funds, which can currently use this method to some extent. The European Fund and Asset Management Association (EFAMA) opposes the ban, arguing that the use of amortised cost accounting by LVNAV funds is restrictive and limited to securities with maturities of 75 days or less (and even then, only if such securities' mark-to-market price lies within 10 basis points of their amortised cost price).

Second, Esma has suggested abolishing the rule that the constant net asset value per unit or share of a low volatility fund should be rounded to the nearest percentage point. That would force those funds to apply the same rules on rounding that currently apply to variable net asset funds, which round to the nearest basis point. This would remove the possibility of stable pricing for low volatility funds and could materially change the European money market fund landscape. The EFAMA is strongly opposed to these changes, as a threat to investor choice and diversity in the European funds landscape. Time will tell who wins. ■

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