RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD

of 20 December 2012

on money market funds

(ESRB/2012/01)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board[1], and in particular Article 3(2)(b), (d) and (f) and Articles 16 to 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board[2], and in particular Article 15(3)(e) and Articles 18 to 20 thereof,

Whereas:

(1) Money market funds (MMFs), while being subject to securities markets regulation, are a key component of the shadow banking system, particularly as they perform maturity and liquidity transformation, and may therefore pose systemic risk.

(2) Investors may perceive MMFs, in particular constant net asset value funds that seek to maintain an unchanging face value, as safe alternatives to bank deposits. However, MMFs do not have direct access to a public safety net, such as central bank financing and deposit insurance. There is therefore a risk of confusion with bank deposits benefiting from such a safety net.

(3) As a rule, MMFs do not benefit from explicit and firm support arrangements by their sponsor companies, often banks, although there have been instances where sponsor companies have ex-post actively supported ailing MMFs on a discretionary basis.

(4) Economic research provides evidence that the conduct and nature of MMFs make them vulnerable to destabilising investor runs, which can spread quickly among funds, impairing liquidity and the availability of short-term credit, in particular for banks. The risk of an investor run may be higher for constant net asset value funds in cases where there is a perception that

1 OJ L 331, 15.12.2010, p. 1.
2 OJ C 58, 24.2.2011, p. 4.

they would fail to live up to investor expectations of redemption at par.

(5) Although MMFs did not cause the financial crisis of 2007 to 2008, their performance during the financial turmoil highlighted their potential to spread, or even amplify, a crisis. The experience from the 2007 to 2008 crisis has shown that MMFs may be susceptible to investor runs and may need the support of sponsor companies, in particular to maintain their constant net asset value.

(6) Potential systemic risks stemming from MMFs therefore relate to the first-mover advantage of investors, specifically relevant for constant net asset value funds, the implicit and discretionary nature of support by sponsor companies, and the high interconnectedness of MMFs with the rest of the financial system, in particular banks and money markets.

(7) Following an assessment of the causes of the recent financial crisis, several national regulators and international organisations have signalled the need for structural MMF reforms. On 27 October 2011, the Financial Stability Board (FSB) published a set of initial recommendations to strengthen the oversight and regulation of the shadow banking system. In particular, the FSB identified as crucial issues to be addressed a mandatory shift to variable net asset valuation, capital and liquidity requirements for constant net asset value funds, and other possible regulatory approaches.

(8) Following a request by the FSB, the International Organization of Securities Commissions (IOSCO) issued on 9 October 2012 policy recommendations aimed at mitigating the susceptibility of MMFs to investor runs. While a substantial part of these IOSCO recommendations is already addressed at European Union level, there are some remaining gaps.

(9) US regulators have worked on revising the framework for MMFs. In particular the Securities Exchange Commission (SEC) has revised its Rule 2a-7. In addition, on 13 November 2012, the Financial Stability Oversight Committee released Proposed Recommendations Regarding Money Market Mutual Fund Reform for public consultation.

(10) In May 2010, the Committee of European Securities Regulators published Guidelines on a common definition of European 'MMFs' in order to establish new common standards addressing the failures identified during the financial crisis. In particular, the guidelines impose strict standards in terms of portfolio quality and maturity, risk management and disclosure. These non-binding guidelines are addressed to both UCITS and non-UCITS MMFs and have been implemented by Member States at national level.

(11) The European Commission has indicated its intention to develop new Union-wide legislative measures on UCITS, surveying in particular the need for more detailed and harmonised regulation on MMFs[3].

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3 Consultation on Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments, 26 July 2012.

(12) In line with Regulation (EU) No 1092/2010, the European Systemic Risk Board (ESRB) may address to the Commission recommendations also in respect of the relevant Union legislation. These Recommendations aim at providing guidance in this respect to the European Commission, as well as to ESMA in its advisory and regulatory role.

(13) While investor runs can occur with all types of funds that have maturity or liquidity mismatches, constant net asset value funds have characteristics that suggest that an investor might seek first-mover advantage in periods of financial market stress. A conversion to variable net asset value funds might reduce the shareholder's incentive to run when the fund has experienced a modest loss and might further increase price transparency. It may also help to address the systemic risks associated with the interconnectedness of MMFs with sponsor companies and reduce the need for and importance of sponsor support.

(14) A general use by MMFs of fair value accounting and, in limited circumstances only, the use of amortised cost accounting, will provide price transparency to investors, improve investors' understanding of the risks inherent to these MMFs, and make the difference between MMFs and bank deposits clearer.

(15) Liquid assets help MMFs pay redeeming shareholders and prevent fire sale of assets at a loss, also preventing contagion effects for other funds that hold similar securities. Accordingly, explicit minimum amounts of daily and weekly liquid assets will ensure that MMFs are able to meet potentially large redemption requests from investors and weather periods of market volatility. Effective tools to deal with liquidity constraints, such as temporary suspensions of redemptions, will assist MMFs in dealing with periods of stress.

(16) Additional public disclosure by MMFs on important features such as the absence of capital guarantee, support by sponsor companies and valuation practices will ensure that investors are clearly aware of existing risks.

(17) More detailed reporting by MMFs will allow supervisory authorities to better understand developments in the MMF industry and to identify sources of risk. Therefore, regular reporting by MMFs should be further enhanced, in particular as regards the composition of their assets and liabilities, the use of amortised cost accounting and sponsor support. Relevant information should be shared by the competent national supervisory authority with other relevant national and European authorities.

(18) In accordance with recital 29 of Regulation (EU) No 1092/2010, the observations of the relevant private sector stakeholders have been taken into consideration for the preparation of this Recommendation.

(19) This Recommendation is without prejudice to the monetary policy mandates of the central banks in the Union.

(20) ESRB recommendations are published after informing the Council of the General Board’s intention to do so and providing the Council with an opportunity to react,

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A – Mandatory move to variable net asset value

The Commission is recommended to ensure that the relevant Union legislation:

1. requires money market funds (MMFs) to have a fluctuating net asset value;
2. requires MMFs to make general use of fair valuation and to restrict the use of amortised cost accounting to a limited number of predefined circumstances.

Recommendation B – Liquidity requirements

The Commission is recommended to ensure that the relevant Union legislation:

1. complements the existing liquidity requirements for MMFs by imposing explicit minimum amounts of daily and weekly liquid assets that MMFs must hold;
2. strengthens the responsibility of the funds’ managers regarding the monitoring of liquidity risk;
3. ensures that national supervisory authorities and funds’ managers have in place effective tools, for example temporary suspensions of redemptions, to deal with liquidity constraints in times of stress resulting from both fund-specific and market-wide developments.

Recommendation C – Public disclosure

The Commission is recommended to ensure that the relevant Union legislation:

1. requires specific disclosure by MMFs, also in their marketing material, that draws the attention of investors to the absence of a capital guarantee and the possibility of principal loss;
2. requires that MMFs refer in their public disclosure to possible sponsor support, capacity for support or protection only if such support or protection is a firm commitment by the sponsor, in which case it must be recognised in that sponsor’s accounts and prudential requirements;
3. requires MMFs to disclose their valuation practices, particularly regarding the use of amortised cost accounting, as well as to provide appropriate information to investors regarding applicable

redemption procedures in times of stress.

Recommendation D – Reporting and information sharing

1. The Commission is recommended to ensure that the relevant Union legislation:
   (a) requires that any instances of sponsor support that may have an impact on the price of the MMF are reported by the MMF or its manager, and the sponsor, to the competent national supervisory authority, together with a full description of the nature and size of such support;
   (b) enhances regular reporting by MMFs;
   (c) ensures that competent national supervisory authorities, where relevant, share the information referred to in points (a) and (b) with other national supervisory authorities within the same Member State, or from other Member States, the European Supervisory Authorities, the members of the European System of Central Banks and the ESRB;
2. The Commission is recommended to promote the development of harmonised reporting and a harmonised data set as mentioned in paragraph 1(b), and the organisation of information sharing mentioned in paragraph 1(c).

SECTION 2

IMPLEMENTATION

1. Interpretation

1. For the purposes of this Recommendation, the following definitions apply:
   (a) 'credit institution' means credit institution as defined in Article 4(1) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions[4];
   (b) 'national supervisory authority' means a competent or supervisory authority as specified in Article 1(3)(f) of Regulation (EU) No 1092/2010.
   (c) 'money market funds' means regulated and supervised Union collective investment undertakings whose primary objective is to maintain the principal of the fund, while providing a return in line with money market rates, by investing in money market instruments or deposits with credit institutions.
   (d) 'variable net asset value fund' means a money market fund that does not seek to maintain an unchanging face value and whose net asset value therefore fluctuates. Its assets are

4 OJ L 177, 30.6.2006, p. 1.

generally valued on a fair value basis.

(e) ‘constant net asset value fund’ means a money market fund that seeks to maintain an unchanging face value. Its assets are generally valued on an amortised cost basis.

(f) ‘amortised cost accounting’ means an accounting approach which considers the acquisition cost of the security and adjusts this value for amortisation of premiums or discounts until maturity.

2. The Annex forms an integral part of this Recommendation. In the case of conflict between the main text and the Annex, the main text prevails.

2. Criteria for implementation

1. The following criteria apply to the implementation of this Recommendation:

(a) this Recommendation covers all MMFs as defined;

(b) regulatory arbitrage should be avoided;

(c) due regard will be paid to the principle of proportionality in the implementation, taking into account the objective and the content of each recommendation;

(d) specific criteria for the implementation of this Recommendation are set out in the Annex.

2. The Commission is requested to communicate to the ESRB and to the Council actions undertaken in response to this Recommendation, or adequately justify inaction. The report should as a minimum contain:

(a) information on the substance and timeline of the undertaken actions, including any actions undertaken vis-à-vis the European Supervisory Authorities;

(b) an assessment of the functioning of the undertaken actions from the perspective of the objectives of this Recommendation;

(c) detailed justification of any inaction or departure from this Recommendation, including any delays.

3. Timeline for the follow-up

1. The Commission is requested to report to the ESRB and the Council on the actions taken in response to recommendations, or adequately justify inaction in compliance with the timelines set out below.

(a) by 30 June 2013, the Commission is requested to deliver an interim report containing a first assessment of the implementation of these recommendations;

(b) by 30 June 2014, the Commission is requested to deliver a final report on the implementation of these recommendations.

2. The General Board may extend the deadline under paragraph 1 where legislative initiatives are necessary to comply with one or more of the recommendations.

4. Monitoring and assessment

1. The ESRB Secretariat:

   (a) assists the Commission, including by providing relevant templates and detailing where necessary the modalities and the timeline for the follow-up;

   (b) verifies the follow-up by the Commission, including by assisting it upon its request, and reports on the follow-up to the General Board via the Steering Committee.

2. The General Board assesses the actions and the justifications reported by the Commission and, where appropriate, decides whether this Recommendation has not been followed and if the addressee has failed to adequately justify its inaction.

Done at Frankfurt am Main, 20 December 2012

The Chair of the ESRB

Mario DRAGHI