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Money Market Fund ('MMF') reform in Europe

Keep calm and carry on

Executive summary

Regulators in Europe have proposed a set of regulations for MMFs that they believe will reduce 'run' risk and the knock on impact to the broader financial system of a 'run' from MMFs.

The release of the reform proposals is another step in a long process, and one that is unlikely to be completed until the first half of 2015. However, it is an important step and, with the expected increase in media coverage of the topic, we thought it was an opportune time to update you on our thoughts on the proposals.

This paper sets out the background to the MMF reform debate, an overview of the proposed reforms, HSBC Global Asset Management's views on the proposed reforms, the expected time line for implementation of the reforms and our views on the potential implications for you as an investor in MMFs.

We do not expect the proposed reforms will remove the utility value that MMFs have provided to investors; professional credit management, credit diversification, a high degree of liquidity, a competitive return compared to short term money market interest rates, all achieved through one transaction. For this reason we believe that investors will continue to use MMFs as part of their day-to-day cash investment needs.

There will be time for investors and providers of MMFs to adjust to these changes with the reforms not expected to take effect until the first half of 2015. Whilst some of the proposed changes are not insignificant, we believe investors and providers will adjust to the changes which will maintain MMFs as an attractive investment option for those looking for a home for their cash.

Background

Regulators in Europe have been considering the reform of MMFs for over two years. This followed their decision that they consider MMFs to be part of the 'shadow banking' system, are susceptible to 'runs' and threaten financial stability. The rationale for these opinions is as follows: investors view MMFs as a potentially safe and more diversified alternative to bank deposits; during a crisis, as asset prices fall, a MMF may not be able to offer immediate redemption at par; not all fund sponsors will be willing or able to provide 'support'; investors perceive a risk and 'run'; consequently the fund has to sell assets to meet redemption requests, thus exacerbating the fall in the price of a fund's NAV; this can lead to systemic risk due to MMFs role in financing the real economy and their link to sponsors.

Early on in the debate, a very small, but influential, number of former and current regulators suggested the answer to the problem of systemic 'run' risk in MMFs was best addressed by requiring 'constant net asset value ('CNAV')' or 'stable price' MMFs to allow the price of the funds to fluctuate. The theory being that if investors are used to the price of a MMF fluctuating they will be less likely to 'run' during a crisis. These early opinions have shaped the debate since, and led to reform options being focused on the reform of CNAV funds. We have always wondered whether regulators would have focused instead on heightened 'run' risk in floating NAV funds rather than CNAV funds if Dexia Bank, an issuer widely held in floating NAV funds, rather than Lehman Brothers, an issuer held in a CNAV fund that defaulted, had not been bailed out…..

An overview of the key reforms proposed by the European Commission

The European Commission recently released its proposal for MMF reform in Europe. The regulation is very comprehensive and includes 44 different proposals covering everything from CNAV funds being required to switch to floating NAV or to hold a 3% capital buffer, to heightened oversight by regulators in Europe.

The following is a summary of some of the more significant changes we see in the proposed regulation:

1. CNAV funds must convert to floating NAV or hold a 3% capital buffer (to be built over 3 years at 1% per year)
2. The introduction of minimum liquidity requirements (10% overnight, 20% within one week)
3. The obligation to maintain a "know your client" policy
4. Prohibition on all use of amortised cost accounting
5. Highly prescriptive credit process
6. MMFs being prohibited from paying for, or soliciting, a fund rating
7. Sponsor support is prohibited, unless approved by the appropriate regulator if they believe the support will reduce systemic risk

HSBC
Global Asset Management

HSBC Global Asset Management's opinion on the European Commissions proposed reforms

HSBC Global Asset Management has been heavily involved in the debate on the reform of MMFs, and we are pleased to see a number of reforms that we have supported included in the Commission's proposal. These include the adoption of minimum liquidity requirements and a "know your client" policy, both of which we believe are necessary to better equip MMFs to manage liquidity risk allowing them to continue to provide liquidity to investors when they require it. We adopted minimum liquidity requirements which are more conservative than the levels proposed by the European Commission and "know your client" policies in 2009, following the credit crisis.

We are also pleased to see regulation on the use of sponsor support and the use of MMF ratings. Early on in our consideration of 'run' risk in MMFs we identified these as issues that should be addressed. Whilst investors understand that MMFs are not guaranteed, the use of sponsor support has created ambiguity about who owns the risk in a MMF. With changes in regulation and sponsor attitude to support, we believe the probability of support being provided in the future by any sponsor is low. For this reason, and more importantly the fact that MMFs are an investment product where the risk is owned by the investor, we believe prohibiting the use of sponsor support creates clarity for investors.

MMF ratings provided a valuable service at a time when there was significantly less transparency provided to investors on the MMFs they invested in and when there was no direct regulation of MMFs in Europe. With very high levels of transparency now common and enhanced regulation planned in many areas, coupled with the increased risk of MMF rating downgrades leading to a 'run' in a MMF, we do not believe the risk / reward trade off now justifies the use of MMF ratings.

However, we are disappointed with a number of the regulatory proposals. Firstly, the requirement for CNAV MMFs to hold a 3% capital buffer or convert to floating NAV indicates that the proposals differentiate between the two types of funds, propensity to 'run' risk, which we refute. Our analysis of the redemption activity in CNAV and VNAV funds during the credit crisis demonstrates both types of funds experienced runs in a small number of MMFs. In our opinion investors redeem from MMFs if they have credit concerns about an asset the fund owns. This will not change because the price of a fund has shown small fluctuations in the past. Furthermore, we believe that the capital buffer requirement will result in CNAV funds converting to floating NAV, thus removing a feature valued by investors without achieving the desired outcome of enhanced stability of the financial system. Secondly, we are disappointed that liquidity fees have not been adopted as a proposed reform to date. Whilst many CNAV MMFs already have this power available to them, we believe formally adopting liquidity fees will enhance the stability of MMFs. Whilst the mechanism is likely to be used very infrequently, if required it can provide a measure of protection to investors who remain in a fund during a period of market stress, as the cost of liquidity is borne by redeeming shareholders, rather than being passed on to remaining shareholders.

The timeline for implementation

The release of the European Commission's reform proposals is an important step forward, however, there is still a lot to be done and a long timeframe before the final regulation is expected to be 'live'.

Below we have outlined the steps to be taken before the regulation is live with an estimated timeframe. As with all regulations, it is difficult to predict timelines with a high degree of confidence. There are many factors that may change the estimated timeline, not least potential changes to the regulation itself.

Q4 2013 – Q2 2014 – The expected timeframe for the regulation to be voted on by the European Parliament and European Council.

Q2 2014 – Q3 2014 – Official adoption into European law.

Q3 2014 – Q2 2015 – Eight months transition period post adoption into law before MMFs must comply with the new regulation.

The potential implications of the reform proposals on the investors in MMFs

Fundamentally, we do not believe that the proposed reforms will remove the utility value that MMFs have provided to investors; professional credit management, credit diversification, a high degree of liquidity, a competitive return compared to short term money market interest rates, all achieved through one transaction. For this reason we believe that investors will continue to use MMFs as part of their day-to-day cash investment needs. In addition, a number of the changes are positive and can help make MMFs even more resilient to any severe market stresses in the future.

However, there are a number of implications of the proposed regulation that we believe investors will need to consider:

1. Conversion to floating NAV
   a. A small level of volatility in the yield of the fund. We are working on an estimate of the expected volatility using historic fund data to provide the necessary context.
   b. Determine whether MMFs will remain "cash and cash equivalents" with your accountants. Whilst we are not regulated to provide accounting advice, and you will need to engage with your own accountants, we are engaging with accountants to get an opinion on this.
   c. Determine the tax treatment of a floating NAV MMF with your accountants. Whilst we are not regulated to provide tax advice, and you will need to engage with your own accountants, we are engaging with accountants to get an opinion.
   d. If your investment policy stipulates that you must only invest in a CNAV MMF this will require updating.
2. MMF ratings – Post the regulation, MMF providers will not be able to pay for their MMFs to be rated. If you would prefer not to pay for a MMF rating for any fund you invest in (assuming this is an option the rating agencies offer), this may require a change to your investment policy if it references a requirement for a MMF to be rated. We are considering what additional information we can provide to you on a regular basis.
3. Treasury system development – The regulatory change may require development of treasury systems to manage investment in a floating NAV MMF.

Clearly the proposals will also require MMF providers, custodians and administrators, and European regulators to adapt to these changes. In the interim we will continue to represent to the European Parliament and the European Council reforms that we believe are in the best interest of our clients, prepare for the changes created by the new regulation, and support our clients to prepare for the changes.

If you have any questions on any aspects covered in this paper or any question on MMF reform please contact your HSBC Global Asset Management sales representative.

Jonathan Curry

Global Chief Investment Officer - Liquidity

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