

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'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.

For Professional Clients and intermediaries within the countries set out below and for Professional Investors in Canada and Institutional Investors in the USA and Singapore. This document should not be distributed to or relied upon by Retail clients/ investors.

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorized reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Global Asset Management at the time of preparation, and are subject to change at any time.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance whilst any forecasts, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in emerging markets are by their nature higher risk and potentially more volatile than those inherent in some established markets. **Before subscription into money market funds, investors and potential investors should consider the investment objectives, charges, expenses and note the general risk factors contained in the fund prospectus. Mutual fund investments are subject to market risks, read all scheme related documents carefully.**

We accept no responsibility for the accuracy and/or completeness of any third party information obtained from sources we believe to be reliable but which have not been independently verified.

HSBC Global Asset Management is the brand name for the asset management business of HSBC Group. The above communication is distributed by the following entities: **in the UK** by HSBC Global Asset Management (UK) Limited, who are authorised and regulated by the Financial Conduct Authority; **in France** by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026); **in Germany** by HSBC Global Asset Management (Deutschland) which is regulated by BaFin; **in Switzerland** by HSBC Global Asset Management

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

(Switzerland) Ltd; **in Hong Kong** by HSBC Global Asset Management (Hong Kong) Limited, which is regulated by the Securities and Futures Commission; **in Canada** by HSBC Global Asset Management (Canada) Limited which is registered in all provinces of Canada except Prince Edward Island and is also registered in the Northwest Territories; **in the United States** by HSBC Global Asset Management (USA) which is regulated by the Securities and Exchange Commission; **in Brazil** by HSBC Bank Brasil S. A.; **in Panama** by HSBC Bank Panama; in Colombia by HSBC Fiduciaria S. A; **in Argentina** by HSBC Bank Argentina SA. Investments in fund shares do not constitute deposits in HSBC Bank Argentina SA. Thus, according to the Argentinean law for financial institutions, they are not covered by any of the guarantees that such deposits, sight or term, might enjoy according to the appropriate legislation and regulation. Likewise, HSBC Bank Argentina S.A. is not allowed, by BCRA regulations, to assume tacit or expressly, any commitment of maintaining at any moment the value of the invested capital, the yield, the value of the shares at redemption or granting liquidity for such end. Law 25,738 (1st art.); HSBC Bank Argentina S.A., is a corporation constituted under the Argentinean republic' law. Its operations are independent from the other companies of the HSBC group. Shareholders limit their responsibility to their subscribed capital. **In India** by HSBC Asset Management (India) Pvt Ltd. which is regulated by the Securities and Exchange Board of India; **and in Singapore** by HSBC Global Asset Management (Singapore) Limited, which is regulated by the Monetary Authority of Singapore. HSBC Global Asset Management (Singapore) Limited, or its ultimate and intermediate holding companies, subsidiaries, affiliates, clients, directors and/or staff may, at anytime, have a position in the markets referred herein, and may buy or sell securities, currencies, or any other financial instruments in such markets. HSBC Global Asset Management (Singapore) Limited is a Capital Market Services Licence Holder for Fund Management. HSBC Global Asset Management (Singapore) Limited is also an Exempt Financial Adviser and has been granted specific exemption under Regulation 36 of the Financial Advisers Regulation from complying with Sections 25 to 29, 32, 34 and 36 of the Financial Advisers Act).

In the U.S., Investment products:

- ▶ **Are not a Bank deposit or other obligation of the Bank or any of its affiliates**
- ▶ **Are not FDIC insured**
- ▶ **Are not insured by any Federal Government Agency of the United States**
- ▶ **Are not guaranteed by the Bank or any of its affiliates and**
- ▶ **Are subject to investment risk, including possible loss of principal invested**

All decisions regarding the tax implications of your investment(s) should be made in connection with your independent tax advisor.

Copyright © HSBC Global Asset Management Limited 2013. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, on any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of HSBC Global Asset Management Limited. 24460/0913 EXP-04/09/2014 FP13-0958