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REPORT

From:	Presidency
To:	Delegations
Subject:	Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Money Market Funds - *Progress report*

I. INTRODUCTION

1. The Commission's proposal for a Regulation of the European Parliament and of the Council on Money Market Funds was transmitted to the Council on 5 September 2013.

2. During the Italian Presidency the proposal was examined by the Working Party on Financial Services at six meetings (3 July, 25 July, 25 September, 30 October, 12 November and 1 December 2014).

3. During the discussions and in order to take into account Member States' concerns, the Italian Presidency tabled two overall compromise texts (documents st 15299/14 and 16185/14). A third compromise text (document st 17008/14) has been issued together with the present report in order to reflect the discussions held at the latest Working Party.

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4. The European Economic and Social Committee and the European Central Bank delivered their opinions on 10 December 2013 and21 May 2014 respectively.

5. The present report has been drawn up under the responsibility of the Italian Presidency, on the basis of positions expressed by delegations in Working Parties under the principle "nothing is agreed until everything is agreed" and without pre-empting their final position on the MMF regulation. This report cannot be considered in any sense as binding on delegations but it represents the Presidency's best assessment of delegations' positions on the key issues related to this file.

II. STATE OF PLAY

6. In general, Member States agree with the aim of the Commission's proposal to establish a European regulatory framework for money market funds to foster harmonisation of rules and investor protection. Nevertheless, a number of provisions of the proposal, in particular relating to the specific treatment of CNAV MMFs are subject to strong reservations. There is, however, a larger degree of convergence on issues relating to the common rules applicable to both VNAV and CNAV MMFs.

7. Eligible assets (Articles 8, 9, 12a, 13, 13a)

   The Presidency has proposed to introduce repurchase agreements and shares of money market funds among the MMFs' eligible assets. The conditions for the eligibility of these assets were defined with the view to preserve the funds from the possible additional risks arising from the widening of the assets where the fund can invest in. While still subject to some reservations, in the view of the Presidency, this approach could ultimately prove acceptable in the framework of an overall compromise.

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8. Eligible securitisations (Article 10)

Broad consensus was reached on a new version of this article, which takes stock of the work done at European and international level to identify simple, transparent and comparable securitisations. According to the Presidency's proposal, the characteristics of eligible securitisations should be defined in a Commission's delegated act.

9. Diversification (Article 14)

The principle of diversification of the MMFs' assets is generally welcomed as a way to limit the riskiness of these funds. Most Member States agreed with the Presidency's compromise, which maintained the rigorous stance proposed by the Commission, while at the same time working on an adequate calibration of the prudential limits. Some Member States suggest providing more flexibility, by aligning MMFs' prudential rules to the limits already foreseen for Ucits; others consider that the Regulation could provide for more stringent diversification requirements, to be assessed also in the light of the treatment of CNAV funds.

10. Credit quality assessment (Articles 16 – 20)

The vast majority of the Member States concur with the goal to avoid overreliance in the external ratings assigned by credit rating agencies. However, many delegations see the internal rating system as overly burdensome. They called for a simplification of the proposed procedure and a proper level of proportionality when dealing in particular with the internal rating system that should be put in place. The latest compromise, still under discussion, provides a specific article (18a), which has been inserted in square brackets; accordingly, it is asked from the Commission to adopt a delegated act which would, inter alia, specify the condition for the application of proportionality.

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11. Solicited credit ratings (Article 23)

Many Member States oppose the ban on the assignment of MMFs' external rating solicited by the MMF itself or by its manager provided for in the Commission proposal. Notwithstanding the possible conflicts of interests resulting from reliance on external ratings, the delegations which would support the deletion of the provision are of the view that the external ratings are an important source of information for investors. Accordingly, there is a need for further discussion of this article in order to bridge the gaps between different positions.

12. Know your customer policy (Article 24)

While recognizing the importance of the "KYC" policy to tackle the liquidity issue arising from large redemptions, Member States support a proper calibration of the measure. Hence, the compromise text proposes more stringent requirements for managers dealing with significant investors. Some fine-tuning may still be required.

13. Valuation rules (Article 26)

The compromise text maintains unchanged the initial proposal of the Commission, which allows the use of amortised cost method to constant NAV money market funds only. However, a not negligible number of delegations see merit in keeping the use of amortised cost method for assets maturing within a limited period, irrespective of the pricing technique (VNAV or CNAV), as is currently permitted by the CESR Guidelines concerning eligible assets for investment by UCITS. Other Member States highlight that allowing the use of amortized cost for assets maturing within a limited number of days would incentivise MMFs manager to concentrate investments in this category of assets.

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14. External support (Articles 35 and 36)

Delegations broadly agreed on a strict limitation of the external support provided to the fund in case of liquidity problems. This orientation is mainly due to the role of the sponsor and to the subsequent contagion effect that the inter-linkages among intermediaries may provoke, as well as the necessity to avoid moral hazard.

Some Member States call for introducing some language in order to define the exceptional circumstances under which the external support would be allowed. Others suggest describing the procedure competent authorities should follow to approve the intervention of sponsors.
Some further reflection on this issue is needed, as it should be seen also in conjunction with other key issues of the Regulation.

15. Specific requirements for constant NAV money market funds (Article 2(12) and 29 and recital 42a) and NAV buffer (Articles 30 – 34)

The definition of the scope and treatment of constant NAV MMFs is the most disputed issue of this file.

The Presidency has followed the nearly unanimous positions of Member States in favour of setting aside further negotiation on the provisions of the Commission proposal introducing a capital buffer aimed at providing a backstop for those CNAV MMFs who aim to maintain a stable redemption value/share also when faced with negative yields or a declining net asset value. Nevertheless, a viable alternative option to deal with the regulatory treatment of CNAV funds and the specific risks they entail has not clearly emerged from the discussions, despite the numerous alternatives put forward by the Presidency and other delegations (low volatility NAV funds, mandatory conversion, liquidity fees and redemption gates, derogation for "small professional investors", variable shares).

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At the outset of negotiations, the Presidency spelled-out six overarching objectives as a guidance of the proposed regulation: i) avoiding unintended consequences on the real economy, preserving the intermediation process; ii) promoting a prudent asset management policy, in particular high liquidity standards; iii) containing moral hazard (both from the demand and supply side); iv) removing the incentives to runs and "cliff effects"; v) reducing contagion, in particular amongst MMFs and between the MMFs and the sponsoring entities (typically banks); vi) avoiding regulatory arbitrage at cross-sectorial and cross-border level. These objectives were met by a large consensus which served as a basis for the examination of several policy options regarding the treatment of CNAV funds.

In order to reach the above mentioned objectives, the Presidency, given the difficulties of pursuing the approach based on NAV buffer, proposed – through a non-paper – an approach based on a mandatory transformation of CNAV funds into a new class of MMFs called **Low Volatility NAV** (LVNAV) MMF. Under the partially fluctuating regime of this new class of funds, the event of "breaking the buck" is not (as in the CNAV regime) an extremely rare event (tail risk), which triggers a panic among the investors even when the fund's portfolio is not seriously affected, but rather is a negative situation that should be perceived by the investors as a serious but not a dramatic event. As a consequence of that, the risk of contagion through panic should be contained. Clearly, LVNAV MMFs as well as VNAV funds are subject to early redemptions, but the destabilizing "cliff effect" should be greatly reduced. The LVNAV MMFs would make use of the so called "penny-rounding method". In particular the NAV is rounded to the nearest cent per share, e.g. €1.00 share price would remain stable as long as the unrounded NAV remained between €0.995 and €1.005. This method is also called "10 basis point rounding".

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The proposal was complemented with a “policy package” which included liquidity fees and gates, supported by an approach based on a “structured discretion” (i.e. conditional to the board of director’s decision); extensive disclosure and reporting requirements, including daily publication of the “shadow NAV”; rigorous liquidity standards (i.e. 10% daily and 30% weekly liquid assets) and a limited use of amortized costs method, below the IOSCO recommendations (i.e.< 90 days). In addition, assets valuation should be provided by a third independent party. The LVNAV approach allows for intra-day liquidity.

While the LVNAV approach obtained interest from a number of MSs, a major obstacle was the impossibility to overcome the phasing-out problem: some MSs considered the LVNAV as a permanent regime, while others wanted to have a mandatory transformation of LVNAV into VNAV only after a transitional period. The solution advocated by the Presidency of introducing a “review clause” after a determined period of 2 to 5 years was not considered as a suitable compromise.

During the semester, various non-papers not produced by the Italian Presidency have been discussed.

One proposal elaborates on practical procedures for a full transition from CNAV to VNAV, in the context of the conversion of the US prime CNAV MMF market. It proposed a **gradual transformation of CNAV into VNAV** through a combination of different tools, including intermediary steps such as penny-rounding or a temporary use of the amortized costs methods. The document elaborates on other practical aspects such as the accounting, tax and same day settlement issues. The non-paper explains notably that a pragmatic conversion process would permit a full compliance with international policy recommendations on financial stability whilst preserving key features offered by VNAV and CNAV funds, such as same day settlement or cash equivalency.

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An alternative non-paper, proposes a set of rules for CNAV MMFs. This proposal retains many of the features of **CNAVs with several new safeguards** to address risks associated with this form of MMF. The proposal includes mandatory conversion to VNAV in the event that the measures fail to resolve the risk of a run. The key elements of this proposal include, among other aspects, liquidity requirements and liquidity fees and redemption gates (complemented by a framework based on the "structured discretion" of the MMF board). In addition, the proposal underlines that, in order to contain moral hazard, sponsor support to the MMF should be substantially reduced and tightly framed, limiting it to exceptional circumstances.

The Presidency's latest compromise allows the management of CNAV MMFs to certain categories of investors (i.e **"Small Professional Investors" exemption**). This class of investors usually do not react instantly to a downward scenario, having typically a longer investment perspective. The proposed approach has not met sufficient support.

Finally, in addition to the "Small Professional Investors" proposal, during the Italian Presidency the approach based on the **"Variable Share mechanism" (VSM)** was circulated for written comments. The rationale of this approach is the following: in the current low interest rate environment, CNAV MMFs find it difficult to maintain a stable net asset value per share, as the net asset value declines, the fund cannot redeem at the initial subscription price per share any longer. In the absence of sponsor support to cover the difference between the stable redemption price and the actual decline in the shadow NAV, the VSM can accommodate these situations. Under this approach, when asset values decline or net investment income is negative, an appropriate number of shares will be cancelled from the investor's holding in order to maintain a stable net asset value per share. In such circumstances the number of shares held by an investor would decrease and, in absolute terms, the investor will get back less than he/she originally invested. This mechanism reflects volatility not in terms of the price of an individual share but in the number of shares in the investor's holding as well as in the monetary amount of the investor's holding.

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VSM can, in principle, function on the basis of a constant NAV that is calculated according to mark-to-market, mark-to-model or amortized cost in parallel to a "real" NAV that is calculated according to mark-to-market or mark-to-model, but not amortized cost. As long as deviations between the constant NAV/share and the "real" NAV/share do not exceed a certain threshold, e.g., 10 basis points, same day valuation at amortized cost and redemption can be maintained at constant NAV/share. For MMF that do not have recourse to amortized cost, same day valuation and redemption under VSM can also work as long as mark-to-market valuations are carried out before a, e.g., mid-day, cut-off date with redemptions taking place in the afternoon. This approach allows CNAV to continue to price their shares at constant NAV on condition that the spread between constant NAV and the NAV based on market prices or a mark-to-model valuation does not exceed 10 basis points. As soon as the spread widens, shares would need to be cancelled or the share price would need to "float". This essential safeguard appears necessary to stabilise the CNAV MMF sector and increase its ability to survive without recourse to sponsor support.

In light of the above considerations, the Presidency believes that a compromise on how CNAV MMFs value their share price is worth further exploring. It appears promising to take up negotiations considering elements from the LVNAV approach or from the VSM, in order to find a pragmatic and feasible solution.

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III. CONCLUSION

16. Against this background the Working Party on Financial Services (MMF) is invited to:

- take note of the progress achieved with regard to the proposal;

- take note of the latest Italian Presidency's compromise text as set out in doc. 17008/14 EF 360 ECOFIN 1204 CODEC 2534;

- invite the incoming Latvian Presidency to continue work on the basis of this compromise text in order to reach an agreement on a general approach in the near future.

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