Deutsches Aktieninstitut

Money Market Funds and the Real Economy

The Role of Money Market Funds for the Management of Cash Reserves and as a Source of Finance Needs to be Respected

Position Paper of Deutsches Aktieninstitut on the Regulation of Money Market Funds, 4 December 2013

Summary

Deutsches Aktieninstitut[1] appreciates the opportunity to respond to the EU Commission's proposal on a Regulation of Money Market Funds of 4 September 2013. This position paper reflects the point of view of companies from the real economy on this issue and is supported by the Bundesverband der Deutschen Industrie (BDI).[2]

Money market funds (MMFs) play an important role in the management of cash reserves for many companies.

They allow companies to diversify their cash reserves in order to reduce the counterparty risks compared to just depositing funds on bank accounts. Also the dependency of non-financial companies on the banking system for cash investments is reduced. However, non-financial companies will not put money into a MMF without assessing the risks of the respective fund. Treasury policies rank security and liquidity of cash management instruments far above yield. As a consequence, cash will usually only be channelled into first class and transparent MMFs with an AAA-rating.

Against this background it is the companies' interest that MMFs act responsibly and credit risks of MMFs' assets are managed effectively. The experience of the non-financial companies shows that this already is the case today.

Nevertheless, Deutsches Aktieninstitut supports a number of key provisions of the Commission proposal such as the obligation to register and the increased transparency requirements. This will surely improve the already high level of reliability, security and transparency of MMFs and may further strengthen their role in the cash management of non-financial companies.

However, the proposal goes too far with respect to a number of important issues. As a consequence MMFs will no longer be able to play their role for companies. Such an unintended negative consequence should be prevented in any case.

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[1] Deutsches Aktieninstitut e.V. (DAI, www.dai.de) is the association of German exchange-listed stock corporations and other companies and institutions interested in the capital market development. The views presented in the paper have been developed together with a working group of 30 high-level representatives of the treasury departments of large German non-financial companies, mainly from the DAX.

[2] Bundesverband der Deutschen Industrie e.V. (BDI, www.bdi.eu) is the umbrella organisation of German industry and industry-related service providers. It represents 38 industrial sector federations and has 15 regional offices in the German Länder. BDI speaks for more than 100,000 private enterprises – 98 % small and medium sized – employing around 8 million people. Membership is voluntary.

In particular, Deutsches Aktieninstitut is concerned about two aspects of the proposal:

1. The ban for MMFs to solicit external credit ratings (Article 23) will make it considerably more expensive and complex to signal the reliability and the quality of MMFs to investors. Since non-financial companies cannot replicate the credit analysis of credit rating agencies at reasonable costs (if they can do so at all), they will, like many other investors, pull out of money market funds.

   The prohibition to use external ratings in Article 23 should therefore be deleted in order to prevent MMFs drying up from the demand side.

2. The proposal of a capital buffer for constant net asset value funds (CNAV MMFs) under Article 30 will push such funds out the market because they will no longer be attractive from a risk-return perspective. When non-financial companies invest cash in MMFs they choose in most cases CNAV MMFs. This is done for accounting reasons and because only CNAV MMFs provide access to cash on a same day basis at a constant value. In contrast, VNAV funds are usually no alternative for the liquidity management of non-financial companies, because they usually will not be recognised as a "cash equivalent" under accounting rules and do not provide same day access to funds at a constant unit price.

   The mandatory capital buffer according to Article 30 should therefore be omitted. Otherwise, non-financial companies (like other investors) would actually be closed out from investments into MMFs.

If these elements of the proposal will not be deleted, European MMFs will be harmed seriously. Furthermore also other requirements of the proposed regulation will lead to higher costs and/or lower returns of MMFs of both types. This is particularly true for the rigorous internal rating procedure and the limits to securities lending und similar activities. These provisions need to be adjusted to keep the business model of many MMFs viable.

If the regulation is not changed risks in the financial system will likely increase. Companies (and other investors) will increasingly deposit their cash positions unsecured with banks again, which will exacerbate the "too big to fail"-problem and will reverse the beneficial diversification effect in the cash management. The dependency on the banking system will increase and counterparty risks will rise again. Thus, the MMF regulation will likely conflict with other regulatory objectives such as the reduction of counterparty risks and the improvement of risk management.

As another significant downside non-financial companies' financing options will also be negatively affected, because the volume of assets under management of MMFs will probably decrease due to the upcoming regulation. A financing problem will also arise for the issuers of asset backed commercial papers (ABCP), because the rules on eligible assets will limit disproportionately the investment of MMFs in ABCPs. The political objective of strengthening capital market financing in Europe is therefore thwarted.

1 Money Market Funds as an Instrument of Cash Management

Money market funds play a major role in cash management

European MMFs have collected between 26 and 28 percent of their deposits from non-financial companies.[3] Applying this figure to the total liabilities of all money market funds in the euro area (€ 857 billion, Q3/2013, according to ECB data) companies' deposits account for between € 223 billion and € 239 billion. Taking the data of the European Fund Association EFAMA (€ 935 billion, Q3/2013) as a basis one arrives at € 243 to € 261 billion of liquid cash that are channelled into MMFs by non-financial companies.

The important role of MMFs in the liquidity management has the following reasons:

- Many non-financial companies reduce concentration risks in their liquidity position by using MMFs as a means of cash management. Since the financial crisis companies are looking increasingly for alternatives to traditional bank deposits. MMFs offer such an alternative. Diversifying the cash position by using MMFs (which are themselves diversified) reduces the risk profile of cash investments and the overall level of counterparty risks.

- Non-financial companies' treasury policies rank safety and liquidity far above return. Companies therefore assess very carefully where to invest their cash in order to reduce risks. MMFs offer such a safe and liquid means of investment.

- Non-financial companies demand same-day access and an easy transfer of cash to and from their cash management instruments. MMFs meet both demands.

Top rated CNAV MMFs are common

The non-financial companies' concerns with the EU Commission's proposal can easily be understood by taking into account that most companies prefer CNAV MMFs over VNAV MMFs for the purpose of cash management. The use of CNAV MMFs has also economic reasons.

[3] See EU Commission, Impact Assessment, p. 69.

CNAV MMFs offer a daily redemption of deposits at a constant unit price. These features of a CNAV MMF investment allow for their accounting as "cash equivalent" on the side of the non-financial companies. Accordingly, only investments in CNAV MMFs are often considered by the rating agencies as cash and credited against the relevant financial position indicators. In contrast, VNAV MMFs are recognized as short term financial assets, which regularly forces non-financial companies to make daily revaluations of their positions in MMFs. This may have adverse tax implications and may also be relevant for the rating agencies.

As the safety of their cash position is of central importance for non-financial companies, MMFs usually also need to be rated AAA by an independent rating agency before they are even considered as a possible means of investment. Also, cash is usually only deposited with so-called liquidity funds which invest into short term and high quality assets and which comply with the code of conduct of the IMMFA.

Overall, the investment of cash positions into MMFs aims at diversifying counterparty risks and reducing risks of holding cash compared to a situation where cash is deposited in unsecured bank accounts only.

The rating ban should be waived

Credit ratings play an important role for the investment process of non-financial companies, because they help MMFs to signal their creditworthiness to potential investors. As described above, companies pay very close attention which MMFs they chose for the purpose of cash management. Often treasury guidelines demand an external AAA rating as a prerequisite for any MMF investment. Ratings thereby facilitate the company's initial analysis and pre-selection of eligible MMFs. On this basis a more detailed analysis is performed in order to assess whether or not the particular MMF fits into the general structure of the liquidity position of the non-financial company.

The prohibition of external ratings according to Article 23 would force non-financial companies to perform the credit analysis of MMFs completely on their own without the guidance of a second neutral and professional judgement. Given the level of expertise and resources necessary for such a detailed credit analysis, which is performed by rating agencies on a weekly basis, it is highly likely that non-financial companies will not be able to take over the rating agencies' task at reasonable costs.

The prohibition of external ratings according to Article 23 will therefore force non-financial companies (and other investors) de facto to withdraw their investments from MMFs for reasons of cost efficiency. The market for MMFs will probably be damaged, if not dried out. Article 23 should therefore be deleted.

The NAV buffer should be dropped

The EU Commission emphasizes that it is not the objective of the proposed regulation to ban CNAV MMFs because "some investors prefer this particular form of MMF".

Instead, the EU Commission proposes that CNAV MMFs must establish a buffer of at least 3 percent of the total value of their assets (so called NAV buffer, Article 30), which serves to absorb price fluctuations of the assets of the MMF and to guarantee a stable NAV of € 1. This capital buffer must be provided by the parent company of the MMF. In addition, there is the obligation to make additional contributions if the buffer falls below 3 percent (Art. 33).

As a consequence, the capital buffer will make CNAV MMFs economically unattractive. Thus, Article 30 constitutes a de facto ban of CNAV MMFs which is clearly inconsistent with the explicit intention of the EU Commission to maintain CNAV MMFs. Capital buffers have to be financed by the fund providers. Even under conservative assumptions the resulting cost of equity will exceed the usual management fee of MMFs by a factor of 2 to 3. Not only in the current interest rate environment CNAV MMFs will, as a result, become unattractive for non-financial companies and other investors as a result. They will quite likely be pushed out of the market in Europe.

Overall, the proposed NAV buffer will de facto eliminate one of the most important alternative to bank deposits in the cash management of non-financial companies. As argued above CNAV can and will not be replaced by VNAV funds for accounting and practicability reasons by most non-financial companies. The NAV buffer should therefore be dropped in order not to harm the cash management of non-financial companies.

Otherwise, corporates will resort to bank deposits again. The diversification of risks in cash management by substituting bank deposits with MMF investments will be reversed as a consequence. This will not only increase again the counterparty risks of the respective non-financial companies but also macroeconomic risks. Less diversification of non-financial companies' cash positions means higher

concentration in bank deposits which will increase the “too big to fail”-problem and render non-financial companies more prone to contagion risks form the banking system.

Reviewing other proposals

It is worth noting that a number of other requirements of the proposed regulation will also lead to higher costs and/or a lower return for CNAV as well as VNAV MMFs. This is particularly true for the rigorous internal rating procedure (Art. 16-18) which will force MMFs to replicate the work of rating agencies for each asset under management and the very strict limits with respect to entering into securities lending und borrowing agreements, (reverse) repurchase agreements and the borrowing and lending of cash (Art. 8 and Art. 13). In essence, already these additional provisions could make it economically unattractive to set up MMFs irrespectively of whether they are CNAV or VNAV funds. These requirements need to be reviewed in order to keep the business model viable for many MMFs. Otherwise the requirements will add to concentration of the MMF industry.

2 Impact on the Refinancing of Non-Financial Companies

The proposed regulation will also jeopardise the contribution of MMFs to the financing of the real econmy: if investors stay away from MMFs because of the rating ban, the de facto ban of CNAV MMFs and the rising costs, assets under mangement will decrease and so will the volume of financing by MMFs. Accordingly, the affected companies will have greater difficulties to issue short-term securities such as commercial papers as a means of finance. Moreover, the investment rules regarding securitised assets appear to be too strict, so that an important group of investors for asset backed commercial papers (ABCP) will likely disappear.

MMFs play an important role for the short term finance of non-financial companies. Between 6.6 and 11.1 to percent of the assets of MMFs consist of securities issued by non-financial companies.[4] Based on these figures European MMFs provide the real economy with short-term finance of around € 60 to € 105 billion.[5] Thus, they help to ensure the refinancing of companies and reduce financing risks.

This positive contribution is compromised in two respects at least:

1. The rating ban, the NAV buffer and other requirements will make MMFs less attractive for investors. Thus, the assets under mangement will also decrease. Accordingly, companies will indirectly experience greater difficulties to obtain funds from the issuance of short-term securities due to lower demand from MMFs.

2. In addition the proposed rules for eligible assets will directly influence whether and to what extent MMFs will be able to contribute to the financing of the real economy. Especially Article 10 in conjunction with recital (23) is highly relevant for non-financial companies as it defines the range of securitised instruments which will be eligible assets of MMFs. Article 10 para. 1 (a) defines that the underlying exposure of securitised instruments has to consist exclusively of corporate debt of high credit quality and liquidity. Companies of the real economy usually securitise trade receivables, e.g. lease receivables of the automotive industry. These

[4] See EU Commission, Impact Assessment, p. 70 (original data: ESRB survey)

[5] Estimate result by applying either 6.6 percent or 11.1 percent to data on total assets under management (AuM) of MMFs. According to the ECB the Eurozone's MMFs have €856.7 bn AuM (Q3/2013) so that a range of € 56 bn to € 95 bn for the Eurozone alone results. According to EFAMA AuM of MMFs were € 935bn in the third quarter. The range would therefore be € 62 to € 104 bn.

securitisations often meet the requirements of maturity and credit quality of other money market instruments, but will never qualify as eligble assets according to Art. 10 and recital (23). This will happen although securitised automobile loans have proven to be very robust throughout the financial crisis. Apart from that the wording of Article 10 appears to refer to multiple or re-securitisation since the underlying of the securitisation needs to be “corporate debt”, i.e. a financial instrument, rather than trade receivables themselves.

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