PensionsEurope Position on Money Market Funds

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About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace pensions. Some members operate purely individual pension schemes.

PensionsEurope has **23 member associations** in EU Member States and other European countries with significant – in size and relevance – workplace pension systems[1].

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope member organisations cover the workplace pensions of about **80 million European citizens**. Through its Member Associations PensionsEurope represents approximately € **3.5 trillion of assets** managed for future pension payments.

PensionsEurope Members are large institutional investors representing the **buy-side** on the financial markets.

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[1] EU Member States: Austria, Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK, Croatia. Non-EU Member States: Guernsey, Iceland, Norway, Switzerland.

I. Introduction

On 4 September 2013, the European Commission issued a Proposal for a Regulation on Money Market Funds[2]. The proposal is one of the outcomes of the wider debate on the further regulation of the shadow banking system, i.e. the system of credit intermediation that involves entities and activities outside the regular banking system.

The proposal builds upon earlier shadow banking research and analyses of the Financial Stability Board (FSB) and of other institutions such as the International Organisation of Securities Commissions (IOSCO) and the European Systemic Risk Board (ESRB). It has been found that the disorderly failure of shadow banking entities and activities can carry systemic risk, both directly and through their interconnectedness with the regular banking system.

PensionsEurope supports any initiative that is aimed at strengthening the financial sector, and even more so if that would result in a reduction of (systemic) risks. However, PensionsEurope does feel that any such regulation should be proportionate and that institutional investors, occupational pension funds and their asset managers more in particular, should not unnecessarily be restricted in their investment options. Occupational pension funds and their asset managers often invest in Money Market Funds (MMFs), primarily for purposes of managing their liquidity needs on a short-term basis.

II. Key issues

Long-term institutional investors, such as pension funds and their asset managers, also have liquidity needs which are managed efficiently through short-dated instruments like MMFs. For instance, pension funds and their asset managers need to keep a cash surplus for the payments of retirement benefits to pension beneficiaries, or for the refunds of contributions or to transfer values for members leaving service. Additionally, cash reserves are also needed to fund other payments that might arise at short notice such as margin payments for derivatives. In particular, the smaller pension funds that do not have a Global Master Repurchase Agreements (GMRAs) in place make often use of MMFs to take indirect collateralised exposure via reverse repos.

[2] Proposal for a Regulation of the Parliament and the Council on Money Market Funds, COM(2013) 615/2 [Link]

PensionsEurope fears that the proposed regulation of MMFs will drive occupational pension funds and their asset managers out of these types of investments. If this was the case, and taking into account their continuing short-term liquidity needs, alternative short-term products such as repo markets or bank deposits will then need to be considered. This may leave pension funds and their asset managers increasingly exposed to single counterparties, which may also have adverse consequences in terms of required risk/return profiles.

The proposed further MMF regulation may thus, paradoxically, expose occupational pension funds to *increased* risk. It should be noted that PensionsEurope does not want to preclude that one short-term investment option (e.g. in MMFs) is better than others (e.g.in repo markets and/or bank deposits). PensionsEurope considers that each of these investment options serves its own specific objective and by combining them pension funds, regardless of their size, are able to better meet their short-term liquidity needs and diversification objectives.

There are a few reasons why we consider that the proposed regulation would make investments in MMFs, both the variable net asset value (VNAV) and the constant net asset value (CNAV) types, much less attractive. Mainly:

1. The <u>required cash reserves for CNAV funds</u> (currently proposed in the form of a buffer equal to 3% of their assets under management), will make investments in these types of funds much more costly, and consequently these products will become seriously less attractive (or even: unaffordable) investment options for occupational pension funds and their asset managers;
2. The proposed MMF <u>portfolio restrictions</u>, will also turn MMFs into significantly less attractive -or even fully unsuitable- investment options;
3. More flexibility should be allowed regarding the use of credit ratings and internal assessments. The proposed <u>ban on the use of credit ratings</u> (as opposed to the general rules that only prevent an *over*-reliance on credit ratings) would be detrimental for the quality of investment decisions made by pension funds, mainly for the smaller types of pension funds that do not have sufficient resources to develop their own credit-risk assessments. Moreover, the definition of internal methodologies and implementation of credit ratings by MMFs seem excessively onerous, which would likely result in increased costs for investors in MMFs.

In general, in the view of many Members of PensionsEurope, the proposed regulation is to a large extent “overshooting” its aim and unnecessarily prescriptive.

Please find further detail on the above key issues below.

III. Further detail key issues

1. Cash reserves for CNAV funds

CNAV funds allow occupational pension funds and their asset managers to redeem funds on a same day basis, making these types of MMFs suitable for storing cash which may be needed at short notice. The same day basis is very important here as under VNAV only t+1 may be possible, which would lead to a loss of liquidity. MMFs are typically run at low cost. The proposed cash buffer for CNAVs would increase the costs on these types of investments. Not only will those costs need to be passed on to (ultimately) the pension beneficiaries, but a cost increase on the scale as envisaged would also make CNAVs often no longer affordable for pension funds at all. This will result in fewer investment options and more difficulties in terms of portfolio diversification.

PensionsEurope does recognize the issues that can arise in case of a so-called ‘run’ on a CNAV fund, i.e. when the fund would face sudden redemption requests by a large amount of investors. However, in our view alternative measures should be explored rather than creating the now proposed cash buffer. A better way of guarding against volatility and runs could be, for instance, to require the use of redemption fees. By definition, these would be payable by investors on exit in stressed market conditions (a definition of a stressed market condition should be consistent between MMFs). Another possibility could be to suspend redemptions for a period of time. Both alternative options would allow preserving fairness between the withdrawing investors and the continuing investors. Alternatives like these should thus be explored rather than increasing the costs of investing in MMFs and therefore creating an (indirect) disincentive for investors, including pension funds and their asset managers, to invest in CNAV funds at all.

2. Portfolio restrictions

As for MMFs in general, particularly the following portfolio restrictions would result in these funds becoming far less attractive investment options:

(1) Repurchase agreements should not be prohibited but should be permitted, albeit on a temporary basis and up to a limit of 10%. We are generally in favour of reverse repurchase agreements. It is an efficient instrument to invest cash in a safe manner and should be supported rather than restricted;
(2) MMFs should not be unauthorized assets for MMFs. Especially, but not only, in the form of master-feeder or funds of funds these should still be authorized;
(3) Weekly liquidity ratios should be fixed at 15% ;
(4) Diversification ratios should not differ from those applying to UCITS, whether for short-term or standard MMFs. We agree that some client diversification rules and appropriate limits to the exposure to certain institutions should be in place in order to minimise the probability of a sudden redemption. However, we do not see the case for such limits being difference than the ones for UCITS.

The above-mentioned measures are deemed to be excessively restrictive and will result in increased cost for MMFs, which most likely will be finally transferred to investors in MMFs such as pension funds and their asset managers. In addition, pension funds and their asset managers would also be negatively affected as they will have fewer counterparties to engage with in their repo and reverse repo transactions, resulting again in unjustified costs for pension funds.

3. Use of credit ratings

It is PensionsEurope´s view that more flexibility should be allowed regarding the use of credit ratings on MMFs. The full loss of independent credit ratings for MMF investments, as proposed by the Commission, would negatively affect European pension funds, especially the smaller pension funds which have more limited access to own credit research teams and (also) require high-quality assessments from external providers to inform their own investment decisions. Other less restrictive measures would be preferred, such as combining the use of external credit risk assessments with internal credit ratings, in particular through the promotion of due diligence when using credit ratings.

Moreover, there should be more flexibility in the definition of the internal methodology and implementation of internal credit ratings by MMFs. The contrary would likely result in increased costs for pension funds investing in MMFs.

MMFs will take the form of either UCITS or AIFs. These investment funds are subject to the rule to ‘only’ not *over*-rely on external credit ratings. Specific MMF rules should (and, considering the maximum harmonization character of both the UCITS and the AIFM Directive: can) not be too prescriptive.

IV. Interconnectedness with other types of financial regulation

1. Derivatives regulation and the need for short-term cash

We note that central clearing and same-day margining regulations in relation to derivatives transactions may increase the needs for short-term cash even more, as investors are increasingly likely to need to post cash collateral to a clearing broker at short notice.

This would require pension funds to increase their cash reserves, whereas pension funds generally minimise their allocation to cash in order to maximise the efficiency and return of their investments. The European Commission has previously recognised this to be a problem for pension funds in EMIR. Therefore, unless a solution for the use of non-cash collateral as variation margin is found, the pooling of pension funds’ cash balances in MMFs should be a possibility. This enables pension funds to reduce the loss in return that results from having to divest capital from assets to cash – which is effectively an increase of costs and will lead to lower pensions. Now proposed regulations will make access to short-term cash more troublesome.

2. FTT impact on MMFs

Finally, we would like to point out that the financial transaction tax (FTT), if applied in accordance with the current proposal, would hit MMFs at least ‘twice’, being (i) when these funds buy and sell the money market products and (ii) when investors redeem their interests in the MMFs. On the other hand, competitive short-term products, such as bank accounts, could remain outside the scope of the FTT. It shall also be noticed that pension funds (and eventually pension beneficiaries), which under the current FTT proposal are still not exempted from the FTT, would be negatively impacted twice by this “double taxation” when investing their cash reserves in MMFs.

PensionsEurope hereby repeatedly expresses its deep concern about the ratio behind and contents of the FTT proposal, as it would severely hit pension beneficiaries. PensionsEurope opposes the introduction of an FTT and invites the 11 participating Member States to dismiss the proposal. However, should the tax be introduced, then pension funds and financial institutions managing assets on their behalf should be exempted from its application.